

University of Mississippi
eGrove

Industry Developments and Alerts

American Institute of Certified Public Accountants
(AICPA) Historical Collection

2002

Not-for-profit organizations industry developments - 2002; Audit risk alerts

American Institute of Certified Public Accountants

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_indev

Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

American Institute of Certified Public Accountants, "Not-for-profit organizations industry developments - 2002; Audit risk alerts" (2002). *Industry Developments and Alerts*. 666.
https://egrove.olemiss.edu/aicpa_indev/666

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Industry Developments and Alerts by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Not-for-Profit Organizations Industry Developments—2002

Complement to AICPA
Audit and Accounting Guide
Not-for-Profit Organizations

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Not-for-Profit Organizations Industry Developments—2002

Complement to AICPA
Audit and Accounting Guide
Not-for-Profit Organizations

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of not-for-profit organizations with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an Other Auditing Publication as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

The AICPA staff wishes to thank Joel Tanenbaum, Technical Manager, AICPA Accounting Standards; Mary McKnight Foelster, Technical Manager, AICPA Professional Standards and Services; Venita M. Wood, an independent consultant in governmental accounting and auditing issues; and various members of the not-for-profit and governmental accounting and auditing profession and related disciplines, including William V. Allen; Gregg Capin, CPA; John Fisher; Eric V. Formberg; Robert J. Freeman; L. Michael Howard; Mary Jo Koschay; Richard Larkin, CPA; Elliot P. Lewis; Hugh Monaghan; Timothy Morgan, JD; Amanda Nelson, CPA; Jill R. O'Brian; Elizabeth Phillips; Kinney Poynter; Terrill W. Ramsey; John E. Reagan III; George A. Rippey; Fred Rothman, CPA; Scott Steffens, CPA; Robert G. Taylor; Gilbert Tran; and John A. Wise for their assistance and contributions to this Audit Risk Alert.

Lori A. West, CPA

Technical Manager

Accounting and Auditing Publications

*Copyright © 2002 by
American Institute of Certified Public Accountants, Inc.
New York, NY 10036-8775*

All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please call the AICPA Copyright Permissions Hotline at (201) 938-3245. A Permissions Request Form for e-mailing requests is available at www.aicpa.org by clicking on the copyright notice on any page. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

1 2 3 4 5 6 7 8 9 0 AAG 0 9 8 7 6 5 4 3 2

Table of Contents

NOT-FOR-PROFIT ORGANIZATIONS INDUSTRY DEVELOPMENTS—2002	7
How This Alert Helps You	7
Economic and Industry Developments	7
The Effect of September 11 on Not-for Profit Organizations	7
Intense Competition Continues	9
Recruitment and Retention of Qualified People and Volunteers	9
Rebounding Economy	10
Taxation of Internet Sales	11
Regulatory and Legislative Developments	12
Circular A-133 Audit Guidance Update	12
Department of Commerce Implementation of Circular A-110	25
Government Auditing Standards	25
Internal Revenue Service Activities	30
Audit and Attestation Issues and Developments	39
Related-Party Transactions	39
Communication With Audit Committees	45
Audit Documentation	47
Client Acceptance and Continuance Policies	51
Not-for-Profit Organizations That Use Service Organizations	52
Fraud	54
Going Concern	58
2002 Audit and Accounting Guide <i>Not-for-Profit Organizations</i> , and SOP 98-3, <i>Audits of States, Local Governments, and Not-for-Profit Organizations, Conforming Changes</i>	60

Accounting Issues and Developments61

FASB Statements No. 141, <i>Business Combinations</i> , and 142, <i>Goodwill and Intangible Assets</i>	61
Employee Layoffs	62
Subsequent Events.....	63
Internal Control Deficiencies and Audit Processes.....	64
Stock Market Decline and Investments	65
SOP 01-6, <i>Accounting for Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others</i>	67
Embedded Derivatives: Application of FASB Statement No. 133, <i>Accounting for Derivative Instruments and Hedging Activities, to a Not-for-Profit Organization's Obligation Arising from a Split-Interest Agreement</i>	67
Agency Transactions	68
Reporting the Costs of Soliciting Contributed Services	68

Auditing and Attestation Pronouncements and Guidance Update.....70

New Auditing Interpretations.....	70
-----------------------------------	----

Accounting Pronouncements and Guidance Update71

On the Horizon72

New Framework for the Audit Process.....	73
Combinations of Not-for-Profit Organizations.....	74
Costs of Soliciting Contributed Services.....	75
Potential Technical Practice Aids (TPAs)	76

AICPA Audit and Accounting Products and Services76

Industry Conference.....	76
Accounting and Auditing Technical Hotline.....	76
Ethics Hotline	77
Continuing Professional Education Courses	77
Not-for-Profit Organizations Checklists	78
Practice Aids.....	79
Technical Practice Aids	79

References for Additional Guidance.....	79
Federal Agencies—Administrative Regulations	79
General Accounting Office.....	80
Office of Management and Budget.....	81
Other Guidance	82
PCIE Audit Committee Guidance	83
 APPENDIX A—CIRCULAR A-133 AUDIT REFRESHER—	
MAJOR PROGRAMS	85
 APPENDIX B—THE INTERNET—AN AUDITOR’S RESEARCH TOOL.....	96

Not-for-Profit Organizations Industry Developments—2002

How This Alert Helps You

This Audit Risk Alert helps you plan and perform your not-for-profit organization (NPO) audits. The information delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

If you understand what is happening in the not-for-profit industry, and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry information and understanding it.

Economic and Industry Developments

The Effect of September 11 on Not-for Profit Organizations

The terrorist attacks of September 11, 2001, often referred to as 9/11, have had a profound effect on the nation and changed the landscape of daily life in America, perhaps forever.

Charitable contributions were received in unprecedented amounts in response to this single event. As of the end of September 2001, \$675 million had been raised specifically for the 9/11 relief efforts by approximately thirty organizations. The value of all the volunteer time that has been rendered to address this crisis is not included in that amount.

Regarding volunteer time, one should remember that contributed services should be accounted for under Financial Accounting Standards (FASB) Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*. FASB Statement No. 116, paragraph 9, states that “contribution of services shall be recognized if the services received (a) create or enhance nonfinancial assets or (b) require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. Services requiring specialized skills are provided by accountants, architects, carpenters, doctors, electricians, lawyers, nurses, plumbers, teachers, and other professionals and craftsmen. Contributed services and promises to give services that do not meet the above criteria shall not be recognized.” Examples of situations in which it may be appropriate to recognize contributed services are included in paragraphs 195 to 206 of FASB Statement No. 116.

The Internet as a Powerful Fund-Raising Tool

The proportion of the 9/11 contributions received over the Internet was immense. The Red Cross reported that over 30 percent of the \$211 million they have received since the disaster was raised over their Web site. This illustrates how powerful a tool the Internet can be in raising funds on an ongoing basis as well as in response to specific events. It also raises information technology (IT) infrastructure issues for many charities as they try to keep up with the volume of donations received over the Internet.

According to a study sponsored by the AOL Time Warner Foundation, charities received \$150 million from online donations, or 10 percent of an estimated \$1.5 billion in individual donations for relief efforts. Before 9/11, online giving accounted for less than 1 percent of U.S. charitable giving. The Association of Fundraising Professionals estimates that 18 percent of its 25,000 members partake in online fundraising, and it is anticipated that that number will rise.

Weak Economy and Fund-Raising Challenges

NPOs have had to reevaluate their fund-raising efforts to ensure that they are not completely overshadowed by the events of 9/11.

Although many contributions appear to be new, there is much concern in the community that contributions have been redirected away from charities other than disaster relief or human service organizations. This is of particular concern given that endowments are weakening due to stockmarket declines and predisaster contributions were not exhibiting much strength. Owing to the deteriorating economy, various organizations have reported dwindling support in 2001 compared to 2000, before 9/11.

Charities face fund-raising challenges because of a shrinking number of philanthropic dollars and growing demand for social services. NPOs are doing what they can to survive these slow economic times, and what they can do hinges on their size and budgets.

Intense Competition Continues

Fierce competition among NPOs continues for donor dollars, as the number of NPOs, already over one million in number, continues to grow each year. They can be as competitive as businesses or governmental agencies in protecting their territory. One NPO, for example, may have a significant increase in contributions as it benefits from a well-executed media campaign, while negatively affecting other organizations. Also, NPOs face increased competition from for-profit businesses. For example, governments that previously focused on NPOs as the recipients of social services contracts now outsource a greater part of their social service functions to for-profit businesses in areas such as welfare-to-work programs, foster care programs, juvenile corrections, and special education.

Recruitment and Retention of Qualified People and Volunteers

Another big issue for NPOs is the recruitment and retention of qualified people. Making the right hire is critical during a slow economy when the risk of layoffs become visible. NPOs, especially with limited budgets, need to hire cautiously to avoid what could be a costly error. Also, NPOs often cannot match the salaries offered in the for-profit environment and, as a result, suffer from high turnover. The other changing dynamic is the nature of volunteers. Volunteers are no longer signing up for long periods of time but rather for a specific activity or event. Auditors

should be aware of the impact on internal control caused by rapid turnover and the increasing use of volunteer staff.

Rebounding Economy

There is evidence that the economy is rebounding. Consumer spending increased 0.6 percent in February, following a comparable gain in January. Personal income also climbed to 0.6 percent, exceeding analysts' expectations for the largest monthly gain since October 2000. Moreover, the consumer confidence level climbed to 110.2 in March 2002, the highest level since the terrorist attacks. Consumer spending accounts for two-thirds of the gross domestic product. So, as personal income rises, consumers are opening their wallets more liberally, bolstering expectations for an economic recovery.

Currently, most of the economic news is positive. With consumer confidence increasing, new and existing home sales stabilizing, the industrial sector expanding, and corporate profits possibly recovering, solid economic expansion could be on the way. However, consumer confidence could be dampened by rising gasoline and energy prices which could reduce consumer purchasing power. Also concerns about job security are developing as the number of U.S. workers filing first-time claims for unemployment benefits rose, up 18,000 to a two-month high at the end of March 2002.

The Federal Reserve Board (the Board) interest rate of 1.75 percent, a forty-year low, has remained unchanged in the first quarter of 2002. For the first time since November 2000, the Board affirmed that risks are now evenly balanced between economic weakness and inflation. Most experts expect the Board to eventually start reversing some of the eleven rate cuts taken last year, which managed to keep the recession the mildest in post-World War II history. Since some stimulants to growth could be temporary and since there is no impending eruption of inflation, the Board can take a wait-and-see approach for a sound recovery before an increase in rates is enacted.

Taxation of Internet Sales

For the past few years, we have alerted you to the continuing debate over the taxation of Internet sales. The District of Columbia, forty-five states, and thousands of local governments impose sales taxes. State and local governments are concerned about losing sales and use tax revenues because of untaxed Internet sales. A recent study of tax revenue lost because of the nontaxation of Internet sales puts the amount at \$440 billion over the next ten years. Internet businesses claim that disparities in sales tax systems among the various jurisdictions are too burdensome to administer.

When we left the saga of the taxation of Internet sales in last year's Alert, Congress had been unable to pass Internet taxation legislation because of serious differences of opinion about whether and under what conditions state and local governments should be able to impose sales taxes on Internet sales. A ban on new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce, first legislated in 1998, expired in October 2001 and was reinstated through November 1, 2003, by the Internet Nondiscrimination Act (P.L. 107-075). The law did not address any issues relating to conditions for eventual Internet taxation, which was addressed in a report to Congress in 2000 that had recommended it take steps to simplify state and local sales and use taxes.

Over thirty states are attempting to simplify and modernize sales and use tax collection and administration through the efforts of the Streamlined Sales Tax Project, which is developing the Streamlined Sales Tax System (SSTS). The SSTS would provide incentives for out-of-state vendors to collect sales taxes when they are not otherwise required to do so, including the following:

- Uniform definitions of taxable products and services
- Liability relief to sellers for inappropriate claims of tax exemption by buyers
- A single tax rate per jurisdiction
- State responsibility for distributing taxes to local governments

-
- Uniform rules for determining the state that is the source of a sale
 - Limited tax audits on sellers
 - State financing of the system

Help Desk—Additional information about the Streamlined Sales Tax Project is available on the Internet at www.streamlinedsalestax.org.

Regulatory and Legislative Developments

Auditors of NPOs may need to monitor changes in government regulations for various reasons. For example, they may be required to comply with government auditing standards, as specified in the *Government Auditing Standards* (GAS), also referred to as the Yellow Book.¹ In addition, auditors may be required to perform a single audit and comply with applicable rules. A single audit is an audit of an entity's federal financial assistance, as required by the Single Audit Act Amendments of 1996 (the Act), and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133).² NPOs may also be affected by other federal, state, and local laws, such as laws regulating the registration of NPOs and tax laws.

Circular A-133 Audit Guidance Update

2002 Compliance Supplement Issued

The OMB Circular A-133 *Compliance Supplement* (the Supplement) is based on the requirements of the Single Audit Act Amendments of 1996 and OMB Circular A-133. Those requirements provide for the issuance of a compliance supplement to assist auditors in planning and performing the required audits. The

1. Although *government auditing standards* primarily apply to federal assistance, some states have adopted government auditing standards.

2. Instead of single audit, under certain circumstances, program-specific audits may be conducted.

Supplement identifies existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Act and Circular A-133, and use of the Supplement is mandatory.

The OMB issued its 2002 Supplement in March. The 2002 Supplement includes information to help you understand the objectives, procedures, and compliance requirements of 159 federal programs. Part 7 of the Supplement, “Guidance for Auditing Programs Not Included in This Compliance Supplement,” provides guidance to help you determine relevant compliance requirements, audit objectives, and suggested audit procedures for programs not included in the Supplement. Although the primary focus of the work on the 2002 Supplement was to update previously included federal programs, it does add eight programs, three of which result in a new program cluster and one of which is a combination of two previously included programs. The 2002 Supplement is effective for audits of fiscal years beginning after June 30, 2001.

Appendix V of the Supplement lists changes from the 2001 Supplement. The more significant changes in the 2002 Supplement include the following:

- Three compliance requirements are revised in part 3, “Compliance Requirements.” In “Allowable Costs/Cost Principles,” additional information is provided on indirect cost rate determinations. In “Special Tests and Provisions,” the requirements relating to Year 2000 considerations are deleted. In “Davis-Bacon Act,” the requirement to test contractor and subcontractor payrolls is replaced with the requirement to determine whether the nonfederal entity notified contractors and subcontractors of the requirements to comply with the Davis-Bacon Act and obtained copies of certified payrolls. (A similar change for the Davis-Bacon Act is made in Part 6, “Internal Control.”)
- Revisions of Part 4, “Agency Program Requirements,” and Part 5, “Clusters of Programs,” address the program requirements for many existing programs and program clusters for the effect of new laws and regulations or for other reasons.

Help Desk—You may purchase the 2002 Supplement from the Government Printing Office (GPO) or download a free electronic copy from the OMB Web site as discussed in the section entitled “References for Additional Guidance” at the end of this Alert. Further, the Catalog of Federal Domestic Assistance (CFDA) numbers for federal programs often change. You can obtain information about number changes in the CFDA’s list of current-year changes and in its Appendix VII, “Historical Profile of Catalog Programs,” which lists changes since 1965. The table of contents for the CFDA, which can take you to all sections of the CFDA, is on the Internet at www.cfda.gov/public/cat-whatshere.htm.

Data Collection Form Revision and Electronic Submissions

The Federal Audit Clearinghouse (FAC) collects information about Circular A-133 audits on a data collection form for entry into a database that is accessible through its Web site. Last year, the OMB issued a revised form and accompanying instructions to report the results of Circular A-133 audits for fiscal periods ending on or after January 1, 2001. Audits covering fiscal period end dates before January 1, 2001, should continue to use the previous version of the data collection form dated August 1997.

Help Desk—You can complete and submit the new and previous data collection forms electronically at the FAC Web site at harvester.census.gov/sac, as discussed later in this section. The data collection forms and related instructions also are available in PDF versions at the FAC Web site. You can obtain printed copies from the FAC by calling 1-888-222-9907. When ordering printed copies by phone, note that the form number is SF-SAC, and that you must indicate whether you need the new or previous form. You and the NPOs you audit are not permitted to create your own version of the forms.

Questions About the Data Collection Form. Auditors and auditees have adapted well to the change in the data collection form. However, the following information describes a few items in the form that have prompted questions:

- *Multiple Employer Identification Numbers (EINs) (part I, items 5(b) and (c)).* The form requires the auditee to complete an

additional page (page 4) to provide the multiple EINs, if any, covered in the report. Only a small percentage of filers have multiple EINs. The FAC needs information about all EINs covered by the filing to properly identify which organizations are intending to satisfy their Circular A-133 audit requirement with the filing.

- *Other Entities (part III, item 2).* This question asks whether the auditor's report includes a statement that the auditee's financial statements include departments, agencies, or other entities that had a separate Circular A-133 audit that are not included in the auditee's Circular A-133 audit. AICPA Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, paragraph 10.54, states that if the audit of federal awards did not encompass the entirety of the auditee's operations expending federal awards, the operations that are not included should be identified in a separate paragraph in the auditor's report. The form's instructions clarify that an auditee should not submit a reporting package or data collection form if the entity's operations are included in another entity's Circular A-133 audit report.
- *Audit Findings (part III, item 8).* This item asks whether a summary schedule of prior audit findings was prepared. The intent of this item is to determine whether the auditee complied with the provisions of section 315 of Circular A-133. That section requires, in part, that the auditee prepare a summary schedule to report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards as well as all audit findings reported in the prior audit's summary schedule of prior audit findings. However, findings in the prior audit's summary schedule of prior audit findings listed as corrected, no longer valid, or not warranting further action as provided in Circular A-133 need not be included in the current summary schedule of prior audit findings. Some auditees do not have prior audit findings to report but, nevertheless, prepare a summary schedule of prior audit findings stating that there

were no such findings. In that situation, the auditor should answer no to part III, item 8, because, even though a summary schedule of prior audit findings was prepared, it only states that there were no prior audit findings to report.

Auditors are reminded to exercise care in identifying whether or not individual federal awards were received directly from a federal awarding agency, which is a required data field on the data collection form (part III, item 10e). When an award consists of both direct and indirect (received by a subrecipient through a pass-through entity) funds, the auditor should list direct expenditure detail on one line and indirect expenditure detail on another line. The correct classification of awards as direct or indirect is important for identifying cognizant and oversight agencies for audit and for the federal agencies to track awards. You should check the data collection form for obvious misclassifications. For example, programs in the student financial assistance cluster always are direct awards.

On-Line Form Submissions. As we reported in the Alert for the past two years, the FAC now permits online submissions of the data collection form on its Web site in a system called the Internet Data Entry System (IDES). The FAC has received about 60 percent of fiscal-year 2001 data collection forms through the IDES. The OMB and the FAC encourage auditors and auditees to increase their use of the IDES to submit data collection forms.

The IDES makes completing the data collection form quicker, easier, and more accurate. The IDES allows you and your auditees to complete your portions of the data collection form online directly into the system, and to benefit from online edits on the data entered in many items before submitting the form. In fact, the IDES does not permit the form to be submitted online if there are unresolved edit failures. Although the form is submitted electronically through this process, it still needs to be printed, signed, and dated by you and the auditee, and mailed to the FAC with the appropriate number of audit reporting packages.

Errors Noted in IDES Submissions. Reports on 2001 audits filed using the IDES have experienced a rejection rate of about 13 percent, as compared to a rejection rate of about 30 percent in non-

IDES submissions. In addition to the lack of familiarity with the new form, the following are among the reasons for the FAC's rejection of IDES submissions:

- Failure to include all the parts of the reporting package with the data collection form
- Not signing or dating the form
- Listing multiple CFDA programs on one line
- Entering a program name as "none"

The FAC also has been rejecting IDES submissions because auditors or auditees use correction fluid to make changes to the paper copy of the data collection form after electronic submission. This often occurs because the form is submitted through the IDES before the auditor and auditee complete their reviews and identify changes that are needed to the data on the form. For review purposes, auditors and auditees should print the form in draft mode, not in the final mode that is available after the form is submitted. Data collection forms submitted through the IDES are locked when the "submit" button is pushed. If, after submitting a form, you later determine that data in it need to be changed, and the paper copy has not yet been mailed to the FAC with the reporting packages, you can call the FAC and ask them to unlock the form to permit the change. (The FAC is looking into how to enhance the IDES to allow revisions of on-line submissions without having the FAC unlock the form.) However, if the paper copy has been mailed, you will need to submit a revised data collection form in the hard copy format to make the change.

Finally, the FAC has been rejecting IDES submissions because paper copies of the form show different report identification numbers on different pages and are printed in draft form or are printed by using "print screen," which cuts off part of the fields. When an auditor or auditee "creates a session" by beginning the process of inputting data into a form for a particular auditee and audit year, the IDES assigns a report identification number. The auditor and auditee can log off the system and later reenter the session using the report identification number and a password that the auditor or

auditee created when the session began. Sometimes the auditor or auditee loses the password and creates a new session for the same form, completing only the pages that were not filled in and printed during the previous unsubmitted session. If a form is printed in draft or print screen modes and created in different sessions under different identification numbers, the form is never subjected to the IDES edits and never submitted to the FAC database. Therefore, on paper it may appear to the auditor and auditee that they have submitted the form through the IDES, but that is not the case. Instead, the unedited data remain in different files on the Internet and never make their way through the FAC firewalls into the IDES.

Consequently, when submitting a form through the IDES, one should be sure to do the following:

- Work in a single session (thereby creating a single file and report identification number).
- Follow the submit and print instructions.
- Document the password for the session because the FAC cannot retrieve passwords.

One feature of the IDES that has greatly reduced error rates and effort is the ability to upload (rather than manually input) a large number of programs or contracts in the form's listing of federal awards expended (page 3) and a large number of EINs (page 4) from spreadsheet files. Instructions for uploading spreadsheet files are on the FAC Web site. This upload feature, which reduces data entry effort, makes the use of the IDES especially beneficial for auditors of large entities and entities with a large number of federal awards.

Help desk—If you have questions or encounter problems while entering data on the IDES, you can call the FAC for customer assistance at 1-800-253-0696, from 7 a.m. through 5:30 p.m. Eastern time. Customer assistance can help you with your issue while you are on-line with the IDES. You also can email your question or problem to the FAC at govs.fac@census.gov if you do not need assistance while on-line.

Federal Grant Streamlining Program

The Federal Grant Streamlining Program (FGSP) is the result of the Federal Financial Assistance Management Improvement Act of 1999 (P.L. 106-107) (the Act), which requires each federal agency to develop and implement a plan to streamline and simplify the application, administrative, and reporting procedures for federal financial assistance programs. In May 2001, twenty-six federal grant-making agencies submitted to Congress and to the Director of OMB an initial plan to implement the Act by setting forth goals, objectives, approach, status, and accomplishments. As a result of various organizational issues, progress on many of the plan's deliverables has been delayed, but progress continues nevertheless. Recent and upcoming efforts of the FGSP include the following:

- Publication of two plain-English documents about Circular A-133 audits (See the discussion later in this section.)
- Review of FAC operations, finding that in general the FAC was operating well and meeting user needs, although further investigation to improve the reports generated by the database is ongoing
- Development of a common format and template for all federal grant announcements, which is being reviewed by the federal agencies and may be instituted sometime in 2002
- Beginning development of a methodology to identify non-federal entities that expend more than \$300,000 in federal financial assistance annually but that have not submitted Circular A-133 audit reports (The FGSP is reviewing federal payment systems to identify those entities.)
- Review of OMB Circulars A-21, *Cost Principles for Educational Institutions*; A-87, *Cost Principles for State, Local, and Indian Tribal Governments*; and A-122, *Cost Principles for Non-Profit Organizations*, to identify and resolve conflicting or confusing definitions of allowable cost items that appear in all three circulars and have a consistent policy basis (The OMB is expected to issue a notice of proposed rulemaking in the *Federal Register* on this effort in 2002.)

-
- Surveying federal quality control review (QCR) activity and processes. (The FGSP is finalizing its reviews of (a) whether and how QCRs are conducted and whether they give reliable information and (b) grantor agency expectations of the Circular A-133 audit process. The results of those reviews will be presented to the President's Council on Integrity and Efficiency [PCIE] and the federal government's Chief Financial Officer's Council [CFOC]. See also the discussion of the results of certain Circular A-133 audit reviews later in this section.)
 - Recommended that OMB not propose revising OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*, to require that federal agencies offer grantees the option to request cash advances on a pooled basis (The OMB is expected to issue a notice in the *Federal Register* in 2002 concerning this position.)

OMB is asking each federal grant-making agency to submit an annual report to OMB and the U. S. Congress on its progress in implementing the plan for grant streamlining and its performance in meeting the goals and objectives of the Act. The target due date for those reports is June 30, 2002.

Plain-English Circular A-133 Audit Publications

The CFOC published two documents, *Highlights of the Single Audit Process and Single Audit Basics* and *Where to Get Help*, which have been sent to all recipients listed in the FAC database. Those documents provide recipients and grantor agency personnel with plain-English descriptions of the Circular A-133 audit process and information about where to find help obtaining or understanding the requirements. Some of the entities you audit may receive those documents and ask you about them. You also could provide the documents to auditees that become subject to Circular A-133 audit requirements for the first time to help them understand the process. Both documents are subject to revision and, for that purpose, the CFOC is soliciting suggestions for improvement.

Help Desk—The documents are posted on the CFOC’s Web site at www.cfoc.gov/documents/pdf_gmc_pamphlet.pdf and www.cfoc.gov/documents/pdf_gmc_cfoBrochure.pdf. Any suggestions you have for improving the documents should be sent by e-mail to PL106107@os.dhhs.gov.

Orange Book

The PCIE hopes to soon issue a revision of *Federal Cognizant Agency Audit Organization Guidelines*, also known as the Orange Book. The Orange Book, originally issued in 1985, sets forth the responsibilities of the cognizant agencies for audit, addressing areas such as technical advice and liaison, desk reviews of audit reports, reviews of audit organizations and their work, resolution of deficiencies noted during reviews, and processing audit reports. The revision will consider, among other things, the effects of the Single Audit Act Amendments of 1996 and Circular A-133. The revision also is expected to provide guidance to oversight agencies for audit as well as to the cognizant agencies.

Help Desk—When issued, the Orange Book should be available on IGnet, the Inspectors General Web site, at www.ignet.gov. Consider reviewing the Orange Book to gain an understanding of the inspector generals’ processes and how they could affect your engagements.

Circular A-133 Audit Reviews

To obtain more information about the Circular A-133 audits of the grants they administer, many federal Offices of Inspectors General (OIGs) and state-level agencies with oversight responsibilities for Circular A-133 audits are increasing their scrutiny of completed audits through desk reviews, QCRs, and other types of examinations. In last year’s Alert, we discussed some of the problem areas identified by the OIGs. Since then, the OIGs have performed additional reviews and are continuing to report similar problems. Notable among the problems identified by the OIGs are sample sizes that appear too small, a lack of required documentation, a failure to perform (or perhaps to document) required internal control and compliance work, and failure to appropriately apply the risk-based approach to determining major programs. (See the Circular A-133

audit major programs refresher in Appendix A, “Circular A-133 Audit Refresher—Major Programs.”) As a result, the number of referrals by the OIGs to the AICPA Professional Ethics Executive Committee (PEEC) for substandard Circular A-133 audits has been rising. The following paragraphs summarize some of the findings that certain federal agency OIGs have found in their reviews. You should review these summaries to help ensure that you avoid some of the common pitfalls noted.

Help Desk—Among the tools that the OIGs use to perform desk reviews and QCRs are two checklists from the PCIE—the *Uniform Guide for Initial Review of A-133 Audit Reports* and the *Uniform Quality Control Review Guide for A-133 Audits*. Copies of those guides are available on the Internet at www.ignet.gov/pande/audit/psingle.html. Before completing your Circular A-133 audits, consider reviewing the guides to gain an understanding of what the OIGs will be looking for in their reviews. Taking this step will help ensure that your engagements meet the criteria identified.

Department of Health and Human Services. The U.S. Department of Health and Human Services (HHS) OIG not only has identified various quality issues through desk reviews and QCRs, but also has used the FAC database to identify possible errors in Circular A-133 audits for audit quality follow-up and possible referral for substandard work. The major problem noted in these reviews has been a failure by auditors to appropriately apply the risk-based approach for determining major programs. Circular A-133 requires a type A program to be audited as a major program unless it qualifies as a low-risk program. Section 520(c) of the Circular states that for a type A program to be considered low-risk, it must, among other criteria, have been audited as a major program in at least one of the two most recent audit periods. A significant number of type A programs that did not qualify as low-risk programs in 2000 because they had not been audited as major in 1998 or 1999 were not audited as major programs in 2000.

HHS OIG has indicated that ensuring the quality of Circular A-133 audits will continue to be a focus area. It will concentrate significant efforts in the upcoming year on audits of colleges and

universities. In addition to reviewing Circular A-133 audit work, the OIG also will be examining other areas. For example, the office will be looking closely at the cash management practices of colleges and universities.

Department of Labor. In its QCRs, the U.S. Department of Labor (DOL) OIG also has noted problems related to two specific DOL programs: the Dislocated Worker (DW) program (CFDA number 17.255) and the Job Training Partnership Act (JTPA) program (CFDA number 17.250). (Although the JTPA program has been replaced with various Workforce Investment Act [WIA] programs, the issues of cash management compliance discussed in this paragraph are equally applicable to the WIA programs.) The OIG found eligibility problems with the DW program. For example, the eligibility was not adequately documented for over one-third of the individuals served by the program—participants were ineligible, documentation was insufficient to establish participant eligibility, or available evidence made the OIG question whether participants were persons whom the program intended to serve. The OIG found cash management problems with the JTPA program that involved a considerable time lag between the receipt of program funds and payments to vendors. If you audit either of these programs, you should consider the general guidance in part 3 and the specific program guidance in part 4 and 5 of the *Compliance Supplement* when testing both eligibility and cash management.

The DOL OIG also has noted problems concerning (a) the sufficiency of compliance testing and (b) documentation. Design problems with audit tests have resulted in certain federal funds being excluded from the test population. Certain compliance requirements that were applicable in the circumstances either were not tested for internal control or had sample sizes that were inadequate to test internal control for a low assessed level of risk as required by OMB Circular A-133. In most cases, auditors did not document sampling assumptions or methodologies. Auditors did not perform additional procedures to gather sufficient evidence to support the opinion on compliance, even when the audit work performed revealed errors indicating a high-risk system and a high probability of material noncompliance.

Certain other compliance requirements that were applicable in the circumstances received no control or substantive testing, and the auditors failed to document why these tests were not performed. Most notable was the lack of eligibility testing for DOL's training grant programs. Those programs typically have centralized local intake and eligibility systems. If you are testing one of those programs in that situation, you should ensure that eligibility is tested in conjunction with the recipient or subrecipient entity you are auditing, or tested centrally.

Help Desk—The complete report of the DOL OIG reviews is available from its Web site at <http://www.oig.dol.gov/public/reports/oa/main.htm>.

Circular A-133 audits are a primary mechanism for the DOL OIG to obtain assurance that recipients and subrecipients maintain effective internal control over federal awards and report reliable financial information on the use of such awards. Grantees and their auditors should be aware that DOL intends to increase its monitoring and evaluation activities of recipients and subrecipients to obtain additional information about DOL programs for purposes of the audit of DOL's consolidated financial statements.

Department of Education. The U.S. Department of Education (ED) OIG also has performed its share of QCRs during the past year. The most common problem found by the OIG in its reviews is that there is not proper audit documentation for the audit work. You should look at both SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339, and the fieldwork standards in GAS, which include additional audit documentation requirements. (See the discussion of SAS No. 96 in the later section of this Alert entitled "Audit Documentation." Other deficiencies noted by the OIG include audit documentation that refers to working papers that do not exist or that do not include the referenced work; lack of internal control testing as required under Circular A-133 (in a number of cases, there was no detailed testing, and, in others, only some aspects of controls were tested); problems with the application of the risk-based approach to determining major programs; discrepancies in the information contained in the data collection form; and failure to obtain all required management representations.

The ED OIG also has noted that some institutions of higher education are not including certain loan and loan guarantee programs (for example the Federal Family Education Loan Program [FFELP] and the Direct Loan Program) in their schedules of expenditures of federal awards. Section 208(c) of Circular A-133 requires that when loans are made to students but the institution of higher education does not make the loans, the value of the loans made during the year are considered federal awards expended. Section 310(b)(6) of Circular A-133 requires those loans and loan guarantees to be reported either on the face of the schedule or disclosed in the notes to the schedule. If you are auditing an institution of higher education, you should be sure that you are considering these loans and loan guarantees as you go through the process of determining major programs.

Department of Commerce Implementation of Circular A-110

The U.S. Department of Commerce (DOC) issued final regulations in the October 1, 2001, *Federal Register* (66 FR 49827), to implement Circular A-110. The new regulations became effective October 1, 2001, and are codified at 15 *Code of Federal Regulations* (CFR), Part 14. Except for provisions relating to the transfer of federal funds among various cost categories, the final rules are nearly identical to the interim rules issued by DOC in 1998.

Under the interim rules, DOC required prior approval on any rebudgeting request that exceeded ten percent of the total program costs. The final rules require prior approval for rebudgeting only for awards in which the federal share of the project exceeds \$100,000 and the cumulative amount of such transfers exceeds or is expected to exceed ten percent of the total program costs. The final rule clarifies that the ten-percent threshold refers to the total federal and nonfederal funds authorized by the grants officer at the time of the transfer request.

Government Auditing Standards

Help Desk—The Yellow Book documents discussed in this section are available on GAO's Web site at <http://www.gao.gov/govaud/ybk01.htm>.

The GAO's 1994 GAS, or Yellow Book, as amended, is the set of standards you should follow when so required by law, regulation, agreement, contract, or policy for the audits of various entities, including not-for-profit organizations. These standards are an integral part of the requirements for a Circular A-133 audit.

Independence Requirements

In January 2002, the GAO made significant changes to the Yellow Book's auditor independence requirements. Amendment No. 3, *Independence*, applies to all Yellow Book audits for financial statements for periods beginning on or after October 1, 2002. GAO encourages early implementation of the provisions of the amendment.

Amendment No. 3 establishes independence standards for CPAs, non-CPAs, government auditors, and performance auditors. It addresses a range of auditor independence issues, including restrictions on nonaudit services. It affects a significant number of audits, applying to auditors of federal, state, and local governments as well as not-for-profit and for-profit recipients of federal (and some state) grants and loans.

Topics Addressed. Amendment No. 3 addresses when auditors and their organizations are independent from the organizations they audit by defining when personal, external, and organizational impairments to independence exist. The amendment applies not only to auditors but also to specialists—such as actuaries, appraisers, and attorneys—whose work is used in an audit and which the amendment defines as a member of the audit team. If an audit organization is not independent, the amendment generally requires the auditor to decline to perform the work.

Amendment No. 3 adopts an engagement-team-focused approach to independence for matters such as the financial interests of an individual auditor, not unlike the AICPA's Code of Conduct. It requires that audit organizations' internal quality control systems identify impairments to independence and determine compliance with Yellow Book independence requirements.

Amendment No. 3 employs a principles-based approach to independence supplemented with certain safeguards for matters such

as the performance of nonaudit services. With respect to nonaudit services, the Yellow Book rule is more restrictive than the AICPA rule because it prohibits an auditor from providing nonaudit services (except for routine advice or activities) when those services are significant or material to the subject matter of the audit. When the nonaudit service is not material or significant to the subject matter of the audit, specific safeguards are required, including a requirement for a separate engagement team to perform the service. The amendment's provisions relating to nonaudit services have the potential to significantly change auditor-client relationships.

The standard for nonaudit services employs two overarching principles:

1. Audit organizations should not provide nonaudit services that involve performing management functions, or making management decisions.
2. Audit organizations should not audit their own work or provide nonaudit services in situations in which the nonaudit services are significant or material to the subject matter of the audits.

Audit organizations may perform nonaudit services that do not violate the above principles only if all of the following seven safeguards are followed:

1. The audit organization should preclude personnel who provided the nonaudit services from planning, conducting, or reviewing audit work related to the nonaudit service.
2. The audit organization is precluded from reducing the scope and extent of the audit work beyond the level that would be appropriate if the nonaudit work was performed by another unrelated party.
3. The audit organization should document its consideration of the nonaudit service, and document its rationale that providing the nonaudit service does not violate the two overarching principles.

-
-
4. Before performing nonaudit services, the audit organization should establish and document an understanding with the audited entity regarding the objectives, scope of work, and product or deliverables of the nonaudit service. The audit organization should also establish and document an understanding with management that management is responsible for the substantive outcomes of the work.
 5. The audit organization's quality control systems for compliance with independence requirements should include policies and procedures to assure consideration of the effect on the ongoing, planned, and future audits when deciding whether to provide nonaudit services and a requirement to have the understanding with management of the audited entity documented. The understanding should be communicated to management in writing. Documentation must specify management's responsibility for the nonaudit service; management's qualifications to conduct the required oversight, and that management's responsibilities were performed.
 6. In cases in which certain nonaudit services by their nature impair the audit organization's ability to meet either or both of the overarching principles for certain types of audit work, the audit organization should communicate to the management of the audited entity, before performing the nonaudit service, that the audit organization would not be able to perform subsequent audit work related to the subject matter of the nonaudit service.
 7. For audits selected in the peer review, all related nonaudit services should be identified to the audit organization's peer reviewer and the audit documentation made available for peer review.

Help Desk—The AICPA has developed a fact sheet on Amendment No. 3 that discusses its provisions, including nonaudit services that may be performed and those that are expressly prohibited. In addition, the AICPA has developed a comparison of the AICPA and Yellow Book independence requirements.

Both those documents, which are on the AICPA Web site at www.aicpa.org/members/div/ethics/index.htm, explain the differences between the Yellow Book and AICPA independence requirements in general and for the following nonaudit services: bookkeeping, payroll, tax, human resources, information technology, appraisal or valuation, indirect cost proposal or cost allocation plans, legislative and administrative decision-making, internal control self-assessments, and assisting legislative bodies.

Possible Additional Guidance. When GAO issued Amendment No. 3, the AICPA immediately began receiving inquiries from members about the effect of the new requirement on the provision of nonaudit services to audit clients. Those questions were forwarded to the GAO staff. Subsequently, the GAO announced it would be providing additional guidance on the application of the amendment, most likely through the issuance of a question-and-answer document. Look for that guidance on the GAO Web site.

The Auditor's Response. Some auditors have asked what actions they should take now to address the provisions of the amendment, even though they do not yet apply. Although the following lists several actions an auditor could take in advance of the effective date of the amendment to help to ensure compliance, it may be prudent for you to wait until the GAO issues its clarifying guidance on Amendment No. 3 (as discussed above) before proceeding too far:

- Study and obtain an in-depth understanding of the requirements.
- Establish policies and procedures to ensure adherence with the provisions of the amendment.
- Examine current and potential future relationships with Yellow Book audit clients to identify nonaudit services that impair independence.
- Consider possible policies for choosing whether to continue to provide nonaudit services or, instead, audit services, to Yellow Book audit clients for which those nonaudit services would impair independence.

Omnibus Exposure Draft

In January 2002, the GAO issued an omnibus exposure draft entitled *Government Auditing Standards 2002 Revision*, to propose revisions that would affect every chapter of the Yellow Book and add a new chapter on attestation engagements. The proposed revisions would restructure the framework of the Yellow Book, apply standards consistently to the various types of audits, and strengthen and streamline the standards. Concerning the consistent application of Yellow Book standards, for example, the exposure draft would require (a) reporting on internal control and on fraud, illegal acts, and other noncompliance on attestation engagements and (b) documenting decisions related to internal control over data significantly dependent on computerized information systems on performance audits (consistent with the Yellow Book's Amendment No. 1, *Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*). Concerning strengthening and streamlining the standards, for example, the exposure draft would (a) require that audit organizations have a human capital management system and (b) permit agency views on significant findings, conclusions, and recommendations to be provided orally, rather than only in writing. The GAO said it anticipates the proposed revisions to become effective for financial audits of periods ending on or after January 1, 2003, and for attestation engagements and performance audits beginning on or after January 1, 2003. Comments on the proposals were requested by April 30, 2002. At this time, the GAO has not indicated when it expects to issue a final revision of the Yellow Book.

Internal Revenue Service Activities

Intermediate Sanction—Final Regulations

The Internal Revenue Service (IRS) has issued final regulations for Intermediate Sanctions designed to protect donors and charities from insider dealing and excessive compensation for executives. The rules gave the IRS a tool to regulate the activities of exempt organizations, with or without revoking the organization's exempt status. The temporary rules were discussed in detail in last year's

Alert. The final regulations differ slightly from the temporary rules. The effective and applicability dates of the final regulations are January 23, 2002.

NPOs must continue to document how and why they compensate CFOs, CEOs, or others with significant power over an organization. The law not only targets top executives but also their family members and family-controlled entities in which there is a combined ownership interest of more than 35 percent if any receive excess benefits. Penalties will be imposed on any transaction that provides excess economic benefits to a disqualified person (that is, a person in a position to exercise substantial power over the affairs of a public charity or a social welfare organization.) Penalties will also be imposed on transactions involving excessive compensation for executives. The ultimate penalty is revocation of the NPO's exempt status.

Note that section 4958 does not apply to individuals employed by private foundations; executives of such organizations are already subject to similar Internal Revenue Code (IRC) section 4941 self-dealing penalties. Also, NPOs themselves have no liability under section 4958; they are subject to other penalties.

There is a five-year look-back period starting with the transaction date. This means the IRS can look back five years from the date the executive received the excess benefit and impose the tax if he or she was a disqualified person at any time during this period. A parallel five-year look-back rule applies in determining qualifying organizations, if an entity was a section 501 (c)(3) or 501 (c)(4) organization at any time within the five years before the transaction date, section 4958 (e) considers it a qualifying organization.

Exceptions. There are several exceptions to the section 4958 rules, including a binding contract exception as well as an initial contract exception. Binding contracts on September 13, 1995, are exempt until there is a material change. An initial contract between an organization and an unrelated party also is exempt from the rules.

Donor-Advised Funds. The final regulations do not adopt a special rule regarding any donor or adviser to a donor-advised fund; con-

sequently, the general rule will apply to determine whether a donor is a disqualified person. The progressively popular donor-advised funds allow the donor to have a continuing say in the sponsoring charity's use of the donated funds. Even though legal control over their donated funds is not allowed, they potentially do exercise considerable power over the amount, timing, and recipients of distributions from the fund.

Managers Shield Expanded. An excise tax equal to 10 percent of the excess benefit may be imposed on the participation of an organization manager in an excess benefit transaction between an applicable tax-exempt organization and a disqualified person. This tax, which may not exceed \$10,000 with respect to any single transaction, is only imposed if the 25 percent tax is imposed on the disqualified person, the organization manager knowingly participated in the transaction, and the manager's participation was willful and not the result of reasonable cause. There is also joint and several liability on this tax. A person may be liable for both the tax paid by the disqualified person and this organization manager tax in appropriate circumstances.

The final regulations add to the means by which organization managers can protect themselves from such tax. Protection starts with making a decision as to whether an individual is an organization manager. An organization manager is any officer, director, or trustee of an applicable tax-exempt organization, or any individual having powers or responsibilities similar to those of the officers, directors, or trustees of the organization, regardless of title. An organization manager is not considered to have participated in an excess benefit transaction if the manager has opposed the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the organization. For example, a director who votes against giving an excess benefit would ordinarily not be subject to this tax.

A manager's participation in a transaction will not be considered knowing whether the organization's board has satisfied the requirements of the rebuttable presumption of reasonableness for the transaction as discussed in the final regulations. A manager is protected as well if he or she relies on a professional's reasoned

written opinion on matters within the professional's expertise that concludes, based on a full disclosure of all the facts, that an excess benefit transaction has not occurred.

Disregarded Benefits Rule Broadened. This rule addresses the final regulations added to the economic benefits, which are to be disregarded in determining whether an excess benefit transaction has occurred, including employee expense reimbursements paid under an accountable plan. A plan is an accountable plan if (a) the reimbursement is for ordinary and necessary business expenses; (b) the employee substantiates the expenses reimbursed within a reasonable period of time; and (c) the employee must return the unsubstantiated portion of the reimbursement.

Section 4958 Does Not Replace Revocation of Exemption. Section 4958 does not affect the substantive standards for tax exemption under sections 501(c)(3) and 501(c)(4), including the requirements that the organization be organized and operated exclusively for exempt purposes, and that no part of its net earnings inure to the benefit of any private shareholder or individual. In most cases, the imposition of this intermediate sanction will be in lieu of revocation. The IRS has indicated that the following four factors will be considered in determining whether to revoke an applicable tax-exempt organization's exemption status if an excess benefit transaction has occurred. The four factors include the following:

1. Whether the organization has been involved in repeat excess benefit transactions
2. The size and scope of the excess benefit transaction
3. Whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences
4. Whether there was compliance with other applicable laws

Rebuttable Presumption Procedure. The Regulations contain a relatively simple procedure for ensuring that all top officials are in full compliance, and thus not liable for the taxes. The procedure is called creating a "rebuttable presumption of reasonableness." The procedure is not required, but is potentially advantageous to all

persons covered by the new Regulations. A rebuttable presumption of reasonableness arises if a transaction with a disqualified person was approved by an independent board (or an independent committee thereof) that: (1) was composed entirely of individuals unrelated to and not subject to the control of the disqualified person(s) involved in the arrangement; (2) obtained and relied upon appropriate data as to comparability; and (3) adequately documented the basis for its determination. The IRS Web site, www.irs.gov, contains an article which explains how to determine which officials the Regulations cover, the suggested simple procedure to obtain the rebuttable presumption, (which includes who must make the decision, what data must be used, how to document the decision, and when to document the decision), benefits for following this procedure, and a rebuttable presumption checklist for ensuring that these officials are in full compliance.

Other Items to be Noted. The IRS's view of when an insider profits from so-called no-risk contracts, as well as control of the decision-making process for private inurement did not change from the temporary to the final regulations. The final regulations make clear who is a disqualified person and organization manager. They also retain the safe harbor for a manager if that manager did not knowingly participate in an excess benefit transaction.

The final regulations do clarify that a disqualified person can be a financial company as well. The relationship between 501(c)(3) organizations and 501 (c)(4) organizations, or social advocacy groups, are further defined. The final regulation contains a less onerous safe harbor for one of the requirements (obtaining comparability data on compensation) for organizations with annual gross receipts of less than one million dollars.

Publication 1771, Charitable Contributions—Substantiation and Disclosure Requirements

The IRS has released an amendment to Publication 1771 which is intended to help donors and charities understand the rules for documenting charitable deductions. It also provides new guidelines that allow charities to electronically mail documentation to donors. The use of e-mail can speed this process and help charities provide

better service to their contributors. The publication also explains that charitable organizations must provide written disclosure to donors who receive goods or services in exchange for contributions, such as the value of a meal at a charitable fund-raising banquet. Organizations that do not provide a written disclosure are subject to penalty. An advance copy is available on the IRS Web site, www.irs.gov. Paper copies can be ordered by calling the IRS Exempt Organizations Customer Account Service toll-free number, 1-877-829-5500.

The Internal Revenue Service Eases the Requirement for Contribution Documentation

The IRS has announced a new rule, Internal Revenue Bulletin 2002-15, dated April 15, 2002, that alleviates the requirement for obtaining substantiating documentation for charitable contributions. Taxpayers who made donations during the September 11 to December 31, 2001, time frame have been given an extension of time until October 15, 2002, to obtain documentation supporting their charitable contribution, whether a written acknowledgment from the charity or evidence of a good-faith effort to obtain it. In order for a taxpayer to claim a deduction for a donation of \$250 or more, the taxpayer must obtain a written letter or receipt from the charitable organization indicating the amount of cash or describing the item or items received. The document must include a statement indicating whether the charity provided goods or services in return for the donation. If the documentation is not received from the charitable organization, the taxpayer is required to show a good-faith effort to obtain documentation. A copy of a letter or e-mail message requesting the documentation is sufficient evidence of such a good-faith effort.

As a rule, taxpayers who make donations of \$250 or more are required to obtain documentation before filing the tax return on which the donation is deducted. However, because of the flood of contributions after the terrorist attacks, some charities are unable to provide donors with the required acknowledgments in a timely manner. So, in light of this IRS announcement, taxpayers may file their tax returns on time even if they are awaiting documentation.

Employer Leave-Based Donation Programs

Some employers have adopted a “leave-based donation program,” following the terrorist attacks of September 11, 2001. The program permits employees to give up paid vacation, sick, or personal time off in return for the employer’s contribution of specified dollar amounts to charitable organizations. Most probably, the employee assigns the recipient.

Usually, an employee who designates compensation to a charity is still considered to have received it for income tax purposes (Reg. 1.61-2 (c)). In spite of this, the IRS has proclaimed that amounts donated to charity under leave-based programs before January 1, 2003, will not be included in participating employees’ gross income for income tax and payroll tax purposes according to Notice 2001-69. Because no income is recognized, a participating employee will not be entitled to a contribution. Furthermore, employer payments under leave-based programs prior to January 1, 2003, will be treated as ordinary business expenses to the employer instead of charitable contributions.

Stock Option Donations

Corporations can get a charitable deduction for the gift of a stock option as reiterated in Private Letter Ruling 200141018. In this Private Letter Ruling, a corporation (*Z*) gave a charity (*Y*) an option to purchase a specified number of its stock shares at a price equal to the fair market value (FMV) of the stock on the date the option was given. *Y* could exercise the option by paying the required purchase price for shares covered by the option or by a “cashless” procedure whereby *Y* would receive shares having a FMV equal to the net value of the option. The IRS ruled that *Z* would have a contribution deduction when *Y* exercised the option. The amount of the deduction would be the FMV of the stock acquired over the option price or, if *Y* chose the cashless approach, the FMV of the shares received.

Eligible Deferred Compensation Plans

Proposed regulations (REG-105885-99. Published May 8, 2002) provide guidance on compensation deferred under eligible section

457(b) deferred compensation plans to state and local government and tax-exempt entities. The regulations include a brief portion applicable to “ineligible” 457(f) plans.

Corporate Sponsorship

Final regulations (TD 8991. Published April 25, 2002) provide guidance concerning the tax treatment of payments from corporate sponsors to tax-exempt organizations. The regulations retain language on exclusive provider arrangements, eliminate the dollar ceiling on disregarded benefits and provide examples clarifying when a hyperlink to a corporate sponsor’s Web site will constitute corporate sponsorship or advertising.

Private Foundation Transfers of Assets

In Rev. Rul. 2002-28; 2002-20IRB (May 1, 2002), the IRS has provided guidance on the filing obligations and excise tax issues incident to a transfer of assets by one private foundation to one or more private foundations.

Forms 990-PF, 990, and 990-EZ

Practitioners should be aware of a number of important changes made to 990 Forms. The forms described in the following sections should be noted.

Form 990-PF. Form 990-PF includes the following:

- Schedule B, Schedule of Contributors, has been revised for 2001. Instead of attaching a list of certain contributors to Form 990-PF, the foundation must now complete Schedule B and attach it to Form 990-PF. Schedule B provides details concerning donors who gave more than \$5,000 in money, securities, or any other type of property during the year. If the foundation did not have any contributors during the year or did not have any contributors required to be reported on Schedule B, the box (new for 2001) on line 1, Part I of Form 990-PF must be checked.
- If the foundation has a Web site, it must now report its Web site address on line 11 of Part VII-A.

-
-
- The 2001 instructions clarify that the entire Schedule B is subject to public inspection if it is attached to Form 990-PF (filed by private foundations), or if attached to a Forms 990 or 990-EZ filed by Section 527 political organizations. For all other organizations that file Forms 990 and 990-EZ, the names and addresses of contributors are not disclosed. Nonetheless, the remaining information, including the amount of contributions, the description on noncash contributions, and any other information provided will be open to public inspection unless it clearly identifies the contributor.

Forms 990 or 990-EZ. Forms 990 or 990-EZ include the following:

- Section 501(c)(3) organizations required to complete lines 26, 27, or 28 of Schedule A (Forms 990 or 990-EZ), Organization Exempt Under Section 501(c)(3), must prepare the donor lists for their own records to substantiate amounts on those lines. For 2001, these lists are not to be filed with the return. Since Forms 990 and 990-EZ are subject to public inspection and returns are now being posted to the Internet, the IRS has become worried that the donor lists may unintentionally be posted as well.
- The information requested has been expanded to include an organization's Web site to facilitate the gathering of information concerning an organization's activities by interested persons. Although Part III of Forms 990 and 990-EZ included the disclosures of an organization's program services, the experience of the IRS has been that many organizations do not adequately explain them.
- The amount of the organization's gross receipts (calculated by adding back certain expenses that are deducted in determining the organization's total revenue) is requested on the 2001 Form 990 to facilitate return processing by providing a benchmark against which IRS personnel can quickly check their calculations. Gross receipts are used as the basis for assessing the proper penalty for late filing, failure to include any of the information required to be shown, or to show the correct information.

-
- If the organization follows the allocation rules of SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*, the 2001 Form 990 has a box the organization is required to check. SOP 98-2 applies when the organization solicits contributions in conjunction with activities that have elements of one or more other functions and prepares financial statements that are in conformity with generally accepted accounting principles (GAAP).

Audit and Attestation Issues and Developments

Related-Party Transactions

Increased pressures on management to maintain or achieve financial targets may heighten the risk of improper accounting or disclosure of related-party transactions. Related-party transactions lack the independent negotiations as to structure and price that are present in transactions with unrelated parties. Difficult economic times also increase the possibility that the economic substance of certain transactions may be other than their legal form, or that transactions may lack economic substance.

A continuing issue for not-for-profit organizations involves accounting for related entities. This becomes a concern as the complexity of the organizational structures of some not-for-profit organizations increases (for example, some not-for-profit organizations have set up for-profit subsidiaries.) This is not only an accounting issue, but also an issue of public attention. A number of organizations have had negative publicity arising from situations in which the organization has a for-profit arm that is portrayed as being subsidized by the tax benefits available to the not-for-profit organization.

The identification of transactions with related parties is one of the important and yet more difficult aspects of a financial statement audit. This aspect of the audit is important because of the requirement under GAAP to disclose material related-party transactions and certain control relationships, the potential for distorted or misleading financial statements in the absence of adequate disclosure, and the instances of fraudulent financial reporting and mis-

appropriation of assets that have been facilitated by the use of an undisclosed related party.

Related parties and related-party transactions are difficult to audit for several reasons. Foremost, transactions with related parties are not always easily identifiable. For example, a series of transactions in the normal course of operations, individually insignificant, could be executed with an undisclosed related party that in total could be material. Next, although other procedures are ordinarily performed, the auditor relies primarily upon management to identify all related parties and related-party transactions. Finally, such transactions may not be easily tracked by an organization's internal control.

Current accounting guidance with respect to related entities includes, among other pronouncements, FASB Statement No. 57, *Related Party Disclosures*, and SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*.

FASB Statement No. 57 defines related parties and requires certain disclosures regarding material related-party transactions, as well as the nature of control relationships that could result in operating results or financial positions significantly different from those that would have been achieved in the absence of such relationships, regardless of whether there were transactions between or among the related parties.

Related parties are defined in FASB Statement No. 57 to include some of the following which may relate to NPOs:

- *Affiliates of the organization.* An affiliate is a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an organization.
- *Management of the organization.* Management includes persons who are responsible for achieving the objectives of the organization and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors.

-
-
- *Members of the immediate families of management.* Immediate family includes family members whom a member of management might control or influence or by whom they might be controlled or influenced because of the family relationship.
 - *Other parties.* Other parties includes those that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Financial statements must include disclosures of material related-party transactions other than items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those financial statements. The disclosures must include the following:

1. The nature of the relationship(s) involved
2. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
3. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
4. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

SOP 94-3 provides guidance as to whether the financial statements of a reporting not-for-profit organization and those of one or more other not-for-profit or for-profit entities should be consolidated,

whether those other entities should be reported using the equity method, and the extent of disclosure required, if any. The SOP provides guidance for reporting the following:

- For investments in for-profit majority-owned subsidiaries, the guidance in Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, as amended by FASB Statements No. 94, *Consolidation of All Majority-Owned Subsidiaries*, and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, should be followed.
- For investments in common stock of for-profit entities wherein the not-for-profit organization has a 50 percent or less voting interest; the guidance in Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, should be followed subject to the exception in paragraph 7 of SOP 94-3.
- For related not-for-profit organization; consolidation is required if board control and an economic interest (both as defined in the SOP) exist. Consolidation is permitted but not required if the reporting organization has control other than board control and an economic interest. (Certain disclosures are required if the reporting organization has control other than board control and an economic interest but chooses not to consolidate.). In addition, the existence of control or an economic interest, but not both, generally precludes consolidation but requires the disclosures set forth in FASB Statement No. 57.

Auditing Related Parties

SAS No. 45, *Omnibus Statement on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU secs. 313 and 334), provides guidance on procedures that should be considered by the auditor to identify related-party relationships and transactions, and to satisfy himself or herself that such relationships and material transactions are properly accounted for and adequately disclosed in the financial statements.

Related-Party Indicators

An audit cannot be expected to provide assurance that all related parties have been identified. SAS No. 45 lists the following transactions which, because of their nature, may indicate the existence of related parties:

- Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below-market rates prevailing at the time of the transaction
- Selling real estate at a price that differs significantly from its appraised value
- Exchanging property for similar property in a nonmonetary transaction
- Making loans with no scheduled terms for when or how the funds will be repaid

In addition, Practice Alert No. 95-3, *Auditing Related Parties and Related Party Transactions*, includes the following examples of events that may be indicative of transactions with undisclosed related parties:

- Accruing interest at above market rates on loans
- Loans to parties that do not possess the ability to repay
- Services or goods purchased from a party at little or no cost to the organization
- Borrowing at below-market rates of interest
- Loans advanced ostensibly for a valid business purpose and later written off as uncollectible
- Payments for services never rendered or at inflated prices
- Purchases of assets at prices in excess of fair market value

Examining Identified Related-Party Transactions

Once related parties are identified, the auditor should place emphasis on testing material transactions with parties known to be re-

lated to or associated with the reporting entity. The auditor should apply the audit procedures he or she considers appropriate to determine the purpose, nature, and extent of the related-party transaction and the effect on the financial statements. In obtaining sufficient competent evidential matter, the auditor should extend the procedures beyond just inquiry of management. Procedures that should be considered include the following:

1. Obtain an understanding of the business purpose of the transaction.
2. Examine invoices, executed copies of agreements, contracts, and other pertinent documents.
3. Determine whether the transaction has been approved by the board of directors or other appropriate officials.
4. Test, for reasonableness, the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.
5. Arrange for the audits of the intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related-party transactions by the auditors for each of the parties, with the appropriate exchange of relevant information.
6. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

In addition, the auditor may determine that extended procedures should be performed in order to fully understand the transaction.

Identifying related parties and material related-party transactions is a key component of any audit. The likelihood of identifying undisclosed related parties and related-party transactions is enhanced when the auditor maintains throughout the audit an awareness for events that may indicate such undisclosed parties or transactions. By following up on such events and determining whether they are the result of related parties, the auditor enhances the likelihood that related-party transactions are properly accounted for and disclosed

in the financial statements, thereby providing users with relevant information for decision-making.

Communication With Audit Committees

SAS No. 61, *Communication With Audit Committees*, as amended by SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722), requires auditors to communicate certain matters to those who have responsibility for the oversight of the financial reporting process (for example, an audit committee). SAS No. 61, as amended, specifies that the discussion should involve management and include such matters as the consistency, clarity, and completeness of accounting policies and disclosures. The auditor is only required to make these communications in audits of (a) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee and (b) all SEC engagements (as defined). Therefore, in audits of many NPOs, the auditor may but is not required to make these communications. This communication may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the the audit documentation. If those matters that are required to be communicated do not apply to a particular engagement (for example, there were no disagreements with management), documentation is not necessary because no communication was required.

The audit committee members benefit from the auditor's views regarding the quality of the entity's accounting principles as applied in its financial reporting. At the same time, management must be regarded as a critical participant in that discussion. The intimate knowledge of management concerning the day-to-day as well as nonrecurring matters that influence operations and financial reporting is essential to an understanding of the financial information. To meet the objectives of SAS No. 61, the auditor may consider the following:

- *Manner of communications.* Communication should be understandable to all members of the audit committee. The

communications should be tailored to the professional and educational backgrounds of the committee members. Management and the auditor can enhance the accounting and financial literacy of the audit committee members by providing presentations on accounting issues, professional publications, and financial press articles that will help the members understand critical and significant accounting and financial reporting issues.

- *Timeliness of communications.* Discussions with the audit committee should occur frequently enough to ensure that the audit committee members are advised of issues on a timely basis. Timely communication is inherently dependent upon management, the audit committee, and the independent auditor sharing a common understanding of the timetable and key milestones in the financial reporting continuum.
- *Relevance of issues discussed.* Periodic communications with the audit committee need not encompass all accounting principles, estimates, and judgments. Rather, the communications could build on prior communications and address those accounting principles and unusual transactions that are more significant in any particular period's financial statements. Topics that management and the auditor may consider to discuss with the audit committee could include but is not limited to the following:
 - The accounting principles applied by the entity for which acceptable alternative principles are available
 - Judgments and estimates that affect the financial statements
 - Consideration of factors affecting asset and liability carrying values
 - Use of special structures and the timing of actions that affect financial statements
 - Evolving issues and choices that affect financial reporting
 - The frequency and significance of transactions with related parties, particularly those that are not in the ordinary course of business

-
- Unusual arrangements
 - Clarity and transparency
 - Audit adjustments identified in the audit
 - Materiality thresholds and cost/benefit judgments

Auditors may also discuss aggressiveness versus conservatism in financial reporting with the audit committee. Any discussions with the audit committee about the aggressiveness or conservatism of accounting principles should address the manner in which a reasonable range is determined and how choices are made and applied within that range.

Under SAS No. 61, the auditor is required to communicate a number of matters, including the quality of the entity's accounting principles, with the entity's audit committee. The purpose of communication with the audit committee is to provide the audit committee with information that may assist it in overseeing the entity's financial accounting, reporting, and disclosure process. The auditor's attention to the accounting and financial knowledge of audit committee members, the timing of communications, and the delivery of appropriate content in the proper context will enable auditors to provide significant insight and assistance to the audit committee to fulfill its oversight role while observing a high standard of professional practice.

Audit Documentation

SAS No. 96, *Audit Documentation*, supersedes SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), and amends other SASs as well, which provides auditors guidance on the functions, nature, content, ownership, and confidentiality of audit documentation. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002, with earlier application permitted. Auditors should ensure that the audit documentation is sufficient to accomplish the following:

1. Enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of the auditing procedures performed, and the evidence obtained

-
-
2. Indicate the engagement team member(s) who performed and reviewed the work
 3. Show that the accounting records agree or reconcile with the financial statements or other information being reported on

SAS No. 96 states that audit documentation should be sufficient to show that standards of fieldwork have been observed as follows:

1. The work has been adequately planned and supervised.
2. A sufficient understanding of internal control has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter has been obtained through the auditing procedures applied to afford a reasonable basis for an opinion.

In determining the nature and extent of the documentation for a particular audit area or auditing procedure, SAS No. 96 states that the auditor should consider the following factors:

- Risk of material misstatement associated with the assertion, or account, or class of transactions
- Extent of judgment involved in performing the work and evaluating the results
- Nature of the auditing procedure
- Significance of the evidence obtained to the assertion being tested
- Nature and extent of exceptions identified
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed

Auditors should recognize that certain SASs contain specific documentation requirements. In addition, auditors performing engagements under GAS are reminded to refer to those standards for certain additional requirements for audit documentation.

Audit Documentation Retention Policies

Auditors are required to maintain their audit documentation, which is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. It also serves to provide the principal support for the auditor's report and aiding the auditor in the conduct and supervision of the audit.

Cost of storage space, as well as the administrative problems involved in retaining material beyond its useful life, are a few of the important reasons to establish a record retention policy.³ Consideration should be given to the impact that failure to produce subpoenaed records may have on a lawsuit. Determining the proper periods for retaining records is a major decision for practitioners. Records should be preserved for only as long as they serve a useful purpose or until all legal requirements are met. At the end of the retention periods, records should be destroyed so files and filing space remain manageable. It is a good practice to document the firm's retention policy and ensure that the policy is uniformly enforced firm-wide. Once established, the firm should share its record retention policy with its clients.

Before establishing a record retention policy, it is wise to consult with legal counsel to gain an understanding of any relevant statutes. The policy should be reviewed annually and updated, if necessary, in light of changing government or professional regulations and cost of retaining records.

When establishing your record retention policy, address the following issues:

- Before creating any document, consider its likely impact on third parties if it were ever made public.
- Fully document all work performed on an engagement, including client requests.

3. For further information on this topic, the AICPA's *Management of an Accounting Practice Handbook* (Product No. 090407), provides guidance on audit documentation retention.

-
-
- Adhere to a regular, consistently enforced, enterprise-wide document retention policy.
 - Completely review a file at the conclusion of the engagement, while the work is still fresh in the memories of staff. They will best be able to determine whether any documents are missing.

By focusing on the big picture, you can dispose of documents that are not needed and verify that all engagement-related responsibilities have been completed.

Record retention periods vary among firms. One factor some firms use when determining their record retention periods is their state's statute of limitations. These firms' record retention periods generally correspond with the longest statute of limitations prevailing in each state for breach of contract, breach of fiduciary duty, and professional liability claims.

While statutes of limitations are important, other methods to determine retention requirements are more valid:

- State regulations and statutes
- Federal laws and regulations
- Historical information regarding the firm
- Clients' historical information
- Customer service
- Asset protection
- Risk management
- Disaster planning and vital record protection

When developing your record retention periods, determine whether your work-product is being used by others in neighboring states. Accounting firms that operate in more than one state must comply with the statutes and regulations of all the states in which they are doing business. The statute of limitations prevailing in those states could affect any related litigation. Because statutes of

limitations vary by state, consult your firm's legal counsel before establishing a record retention policy.

Client Acceptance and Continuance Policies

QC Section 20.14–.16 of the AICPA Professional Standards provides the following requirements regarding client acceptance and continuance:

Policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client. Such policies and procedures should provide the firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized. Establishing such policies and procedures does not imply that a firm vouches for the integrity or reliability of a client, nor does it imply that a firm has a duty to any person or entity but itself with respect to the acceptance, rejection, or retention of clients. However, prudence suggests that a firm be selective in determining its client relationships and the professional services it will provide.

Such policies and procedures should also provide reasonable assurance that the firm—

- a. Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.
- b. Appropriately considers the risks associated with providing professional services in the particular circumstances.

To minimize the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed, policies and procedures should provide for obtaining an understanding with the client regarding those services. Professional standards may provide guidance in deciding whether the understanding should be oral or written.

Acceptance or continuance of a client engagement may be potentially high risk when the auditor identifies client characteristics including the following:

- Management that lacks integrity

-
-
- Weak financial condition
 - Unwillingness to pay for professional services
 - Management that jeopardizes the entity's continued existence by entering into material high-risk transactions
 - Disregard for internal controls and recordkeeping
 - Management that refuses to sign engagement and representation letters

As part of the evaluation, auditors must carefully evaluate a client's characteristics and, in a number of instances, may need to conclude that servicing a client may be too risky a venture.

Not-for-Profit Organizations That Use Service Organizations

Some not-for-profit organizations use third-party service organizations to process transactions such as to administer financial aid programs, administer trusts, maintain donor mailing lists, process contributions, and perform payroll functions. Service organizations performing such functions generate data that are incorporated in the user organization's financial statements. SAS No. 70, *Service Organizations*, as amended by SAS No. 88, (AICPA, *Professional Standards*, vol. 1, AU secs. 324 and 420), provides the relevant auditing guidance pertaining to these situations.

Auditors are reminded that if an organization uses a service organization, transactions processed at the service organization are subjected to controls implemented at the service organization. Consequently, the internal control of a user organization may include a component that is not directly under the control and monitoring of the user organization's management but is instead under the control and monitoring of the service organization. For this reason, planning the audit may require a user auditor to gain an understanding of the controls at the service organization that may affect the user organization's financial statements. This understanding may be gained in several ways, including obtaining a service auditor's report. Auditors should be aware of the considerations to be taken into account in using the service auditor's report and the re-

sponsibilities of service auditors as discussed in AU Section 324.18 through 324.58 of SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324).

In considering the effect of the service organization on the user organization's internal control, auditors should consider several factors, such as the relationship of the controls of the service organization to those of the user organization. AU Section 324.06 provides that the relationship of the controls of the service organizations to those of the user organization depends primarily on the nature of the services provided by the service organization. If the services provided by the service organization are limited to recording user organization transactions and processing the related data, and the user organization retains responsibility for authorizing the transactions and maintaining the related accountability, there will be a high degree of interaction between the controls at the service organization and those at the user organization. In these circumstances, it may be possible for the user organization to implement effective controls over those transactions. Conversely, when the service organization has been given authority to initiate and execute the user organization's transactions and also retains the related accountability, there is a lower degree of interaction and, therefore, it may not be practicable for the user organization to implement effective controls over those transactions.

As stated in AU Section 324.10, after considering the available information, the user auditor may conclude that he or she has the means to obtain a sufficient understanding of internal control to plan the audit. In assessing control risk at the user organization, the auditor should refer to AU Section 324.11 to 324.16 for such guidance. The auditor may also conclude that information is not available to obtain a sufficient understanding of internal control to plan the audit. He or she may then consider contacting the service organization, through the user organization, to obtain specific information or request that a service auditor be engaged to perform procedures that will provide the necessary information, or the user auditor may visit the service organization and perform such procedures. If the user auditor is unable to obtain the sufficient evidence to achieve his or her audit objectives, the user auditor should qual-

ify his or her opinion or disclaim an opinion on the financial statements because of a scope limitation.

The Auditing Standards Board (ASB) has issued a new Audit Guide entitled *Service Organizations: Applying SAS No. 70*. The Guide includes illustrative control objectives as well as three new Interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods.

Fraud

The recent highly publicized instances of fraudulent financial reporting serve as reminders to auditors of the need to remain alert to possible instances of fraudulent activity and to maintain an appropriate attitude of professional skepticism. Most fraud cases involve management fraud or deliberate deceit by management in working with their auditors.

Not-for-profit organizations face mounting pressure to meet the expectations of “watch dog” groups that monitor the use of their resources. Moreover, the image of the not-for-profit organization has a significant effect on a donor’s willingness to contribute. Negative press can considerably decrease future contributions, the availability of volunteers, and public goodwill. Consequently, management of the not-for-profit organization may be subject to unusual pressure to report certain financial results. Such pressure could be a motivation for management to engage in fraudulent financial reporting. Also, significant fraud risk may exist not as an overstatement of operations, but rather as an intentional understatement of operations so that donors perceive a need to continue to give.

Additional factors that not-for-profits confront are the use of ample numbers of volunteer workers who may not be properly trained or supervised, pressure to restrain managerial expenses resulting in inadequate internal control, scores of locations at which contributions are collected, boards of directors who believe that those involved with the charity would not act in a deceptive manner, inexperienced accounting staff, and dependence on board

members to help in achieving needed goals and services, ensuing in related-party transactions.

Auditing Guidance and Audit Issues

Some of the more common audit issues identified in fraudulent financial reporting include:

1. A willingness by the auditor to accept management's representations without corroboration
2. Allowing the client to unjustifiably influence the scope of auditing procedures
3. Failure to identify risky situations, or ignoring identified audit risks by not applying professional skepticism and revising auditing procedures appropriately

Auditors need to consider such issues as part of their assessment of the risk of material misstatement due to fraud, as required by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

SAS No. 1, *Codification of Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 110, "Responsibilities and Functions of the Independent Auditor"), states that "the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material mistatement, whether caused by error or fraud." In addition, auditors also need to consider SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), and SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), for additional guidance on the consideration of fraud and illegal acts. Also, auditors should refer to SAS No. 1 (AU sec. 230, "Due Professional Care in the Performance of Work"), for additional guidance on professional skepticism.

Among other things, SAS. No. 82:

- Describes the characteristics of fraud. The more the auditor knows about the nature of fraud, the better he or she will be equipped to identify risk factors, assess the risk of

material misstatement due to fraud, and develop an appropriate audit response.

- Requires the auditor to make an assessment as to the risk of material misstatement due to fraud, from the perspective of the broad categories listed in SAS No. 82. The assessment is separate from but may be performed in conjunction with other risk assessments made during the audit. SAS No. 82 also requires the auditor to reevaluate the assessment if other conditions are identified during the fieldwork.
- Provides guidance on how the auditor responds to the results of the risk assessment.
- Provides examples of fraud risk factors that, if present, might indicate the presence of fraud.
- Requires the auditor to document evidence of the performance of the fraud risk assessment, including risk factors identified as being present and the auditor's response to those risk factors.
- Requires the auditor to communicate to management at the appropriate level and, in certain circumstances, directly to the audit committee.

Fraud Risk Factors

The following are a few of the many risk factors discussed in SAS No. 82 that may exist at a not-for-profit organization:

- Domination of management by a single person or small group without compensating controls, such as effective oversight by the board of directors or audit committee
- Inadequate monitoring of significant controls
- High turnover of senior management, counsel, or board members
- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity
- Large amounts of cash on hand or processed

-
-
- Lack of appropriate management oversight (for example, inadequate supervision or monitoring, or remote locations)
 - Lack of appropriate segregation of duties or independent checks

Regardless of when the auditor discovers fraud risk factors or other conditions related to the fraud risk assessment, the auditor should consider their effect on auditing procedures. The auditor should document the risk factors identified, as well as the auditor's response to the risk factors. The fraud risk factors and other conditions identified may cause the auditor to believe that the planned audit procedures are not sufficient to provide reasonable assurance that the financial statements are free from material misstatement. Accordingly, auditing procedures should be planned and performed to specifically address the identified risks.

Maintain Professional Skepticism

Above all, auditors must maintain an appropriate attitude of professional skepticism. This means neither assuming that management is dishonest nor assuming unquestioned honesty; obtaining corroborating evidence for management representations; considering whether misstatements may be the result of fraud; and appropriately designing and performing auditing procedures to address fraud risk factors. The application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud might include the following:

1. Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions
2. Increased recognition of the need to corroborate management explanations or representations concerning material matters such as further analytical procedures, examination of documentation, or discussions with others within or outside the organization
3. The assignment of more senior or experienced personnel to plan and perform certain auditing procedures

Help Desk—For further information on fraud refer to self-study course, *Applying Fraud SAS No. 82 in Governmental and Not-for-Profit Audits* (Product No. 735136kk). Also, auditors should be aware that the ASB has issued an exposure draft of a proposed auditing standard entitled *Consideration of Fraud in a Financial Statement Audit*. This proposed standard would supersede SAS No. 82. A final standard is expected to be issued during the second half of 2002. Readers should be alert to any final pronouncement.

Going Concern

Many NPOs are confronting difficult times as the pool of donations available for everyday charitable programs diminishes as a result of the combined effect of the reallocation of donations to 9/11 disaster relief programs and the instability of the stock market. Pledges being withdrawn or not honored are adding to the difficult times as well. If the economy does not recover quickly and contribution revenue continues to decline, some NPOs may be unable to continue as going concerns.

Be Alert to Conditions that May Indicate a Going-Concern Issue

Be alert to conditions and events that, when considered in the aggregate, indicate that there could be substantial doubt about an NPO's ability to continue as a going concern. In some cases, management's plan for the organization to continue as a going concern may rely on mergers with other organizations. Auditors should consider whether plans for mergers or plans for other significant changes are red flags, warning about an organization's ability to continue as a going concern. Remember that the inadequate evaluation of an entity's going-concern status is cited as a common audit deficiency .

For example, such conditions and events could include the following:

- Negative trends, such as negative cash flows from operating activities
- Adverse key financial ratios

-
- Financial difficulties, such as the need to seek new sources or methods of financing or to dispose of substantial assets
 - Aversion by financial institutions to grant long-term financing
 - Unusual board member turnover
 - Turnover in the fund-raising department
 - Internal matters, such as substantial dependence on the success of a particular project
 - External matters, such as legal proceedings that could jeopardize the entity's ability to operate

In such circumstances, auditors may conclude that, based on such conditions and events, there is substantial doubt about the NPO's ability to continue as a going concern.

Auditing Guidance

SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), provides guidance to auditors in conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS) for evaluating whether there is substantial doubt about a client's ability to continue as a going concern.

Continuation of an organization as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going-concern assumption includes any of the following:

1. An organization's inability to continue to meet its obligations as they become due without significant asset disposition outside the ordinary course of business
2. Restructuring of debt
3. Externally forced revisions of its operations
4. Similar actions

SAS No. 59 states that the auditor has the following two responsibilities related to an organizations ability to continue as a going concern:

-
-
- The auditor should evaluate whether conditions or events identified during the audit, when considered in the aggregate, indicate that there could be substantial doubt about the organization's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.
 - If the auditor concludes that there is a substantial doubt about the organization's ability to continue as a going concern, the auditor should gather evidence and consider the impact of the going-concern uncertainty on the financial statements, the adequacy of disclosures, and the auditor's report.

2002 Audit and Accounting Guide *Not-for-Profit Organizations*, and SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations*, Conforming Changes

The AICPA Audit and Accounting Guide *Not-for-Profit Organizations* is available electronically online or in CD-ROM format. Also, the Guide is available as part of a loose-leaf service or in a paperback edition. The AICPA's online and CD-ROM Guide products allow you to purchase the specific titles you need and includes hypertext links to reference within and between all products. Paperback editions of Audit and Accounting Guides as they appear in the service are printed annually (Product No. 013392kk). Copies may be obtained by calling the AICPA Order Department (Member Satisfaction) at 1-888-777-7077, faxing a request to 1-800-362-5066, or ordering online at www.CPA2Biz.com.

Revisions that will be included in the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* as well as SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*,⁴ which is in an appendix to the Guide, for

4. Some auditors have been unaware that SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is updated annually for conforming changes, including changes resulting from last year's two Yellow Book amendments. Although the AICPA does not normally make conforming changes to SOPs, SOP 98-3 has been, and will continue to be, revised annually to keep it up-to-date for changes in the Yellow Book, single audit literature and processes, and Statements on Auditing Standards..

conforming changes as of May 1, 2002, will include those made to reflect the issuance of the following standards:

- FASB Statements of Financial Accounting Standards through FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
- AICPA Statements of Position through SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*
- AICPA Statements on Auditing Standards through SAS No. 96, *Audit Documentation*
- AICPA Statements on Standards for Attestation Engagements through SSAE No. 11, *Attest Documentation* (AICPA, *Professional Standards*, vol. 1, AT secs. 101-107)

Accounting Issues and Developments

FASB Statements No. 141, *Business Combinations*, and 142, *Goodwill and Intangible Assets*

The provisions of FASB Statement No. 141, *Business Combinations* and FASB Statement No. 142, *Goodwill and Other Intangible Assets*, should not be applied to goodwill and intangible assets arising from a combination between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until the FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinion Nos. 16 and 17 remains in effect for such assets. In addition, when applying APB Opinion Nos. 16 and 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statement Nos. 141, 142 and 144. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, even though that Statement was superseded by Statement No. 144.

Readers should be alert to the issuance of a final standard on combinations of not-for-profit organizations.

Employee Layoffs

More than two million Americans lost their jobs during 2001. Many organizations are instituting layoffs during this economic downturn as a result of shortfalls in meeting income projections. The trend is broad-based, affecting not just struggling organizations. Healthy entities are also using layoffs as a tool to reduce costs and accumulate resources as they maneuver through this economic downturn.

NPOs that are experiencing layoffs should properly account for employee-related termination charges such as severance packages, restructuring charges, and voluntary separation. In addition, organizations should properly account for any legal fees, outplacement services, bonuses, increased unemployment insurance, and educational allowances to assist employees in contending with the loss of their jobs. The following accounting literature provides guidance on accounting issues related to layoffs:

- Emerging Issues Task Force (EITF) Issue No. 94-3 addresses liability recognition for certain employee termination benefits.
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for accounting for curtailments and termination benefits among other issues. Practitioners should refer to paragraphs 6 to 14 for guidance on curtailment and paragraphs 15 to 17 for guidance on termination benefits.
- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*, requires the effect of the curtailment (for example, the termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business), to be recorded as a loss. Practitioners should refer to para-

graphs 96 to 99 for guidance on how to account for plan curtailment. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.

- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, requires that entities providing postemployment benefits to their employees accrue the cost of such benefits. Inactive employees include those who have been laid off, regardless of whether or not they are expected to return to work. Postemployment benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and the continuation of benefits such as health care benefits and life insurance coverage.
- FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed. The financial statement shall disclose if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.
- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, addresses disclosures only and requires the disclosure of the amount of gain or loss recognized resulting from a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event is required to be disclosed.

Subsequent Events

Auditors should also refer to AU Section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), for guidance on auditor's procedures relating to subsequent events. As part of those procedures, the auditor should inquire of and discuss with the plan administrator or other parties performing the plans management function matters involving unusual terminations of participants, such as terminations arising from layoffs.

Internal Control Deficiencies and Audit Processes

Significant layoffs can have a serious effect on an NPO's internal control and financial reporting and accounting systems. For instance, employees who remain at the organization may be overwhelmed by their workloads, under pressure to complete their tasks with little or no time to consider their decisions, or performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect is on internal control.

Additionally, the auditor should consider the possible effects that key unfilled positions can have on internal control. NPOs that have had strong financial reporting and accounting controls could see those controls deteriorate as a result of the lack of employees. Controls over purchasing and contributions receivable collections could also suffer. Layoffs can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs job functions that otherwise would be segregated.) Some NPOs have sought greater efficiencies by implementing cost-cutting measures, such as reorganizing established structures by combining departments or eliminating functions, while at the same time continuing to need skilled personnel capable of implementing and maintaining technological improvements and possessing a knowledge of the regulatory, tax, and unique accounting considerations for this industry. Auditors should consider the impact of such changes on the NPO's internal control. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78 and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), outlines the auditor's responsibilities with regard to considering a client's internal control in planning and performing an audit.

Layoffs of IT personnel may have a negative effect on the organization's ability to initiate, process, or record its transactions, or maintain the integrity of information generated by the IT system. Also, the impact of changes to the control environment may alter internal control effectiveness and potentially result in material control weaknesses.

Auditors should consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may cause control weaknesses representing reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended.

Stock Market Decline and Investments

Many not-for-profit organizations are experiencing decreased revenues due to losses on investment portfolios caused by market declines and lower investment returns caused by decreasing interest rates. The declining market value raises issues about accounting for investment gains and losses. FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, requires that investments in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value with gains and losses included in a statement of activities. However, FASB Statement No. 124 does not include within its scope investments in equity securities that are accounted for under the equity method or to investments in consolidated subsidiaries, nor does it apply to investments in derivative instruments that are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Unrealized gains and losses arise when there are changes in the fair value of investments that are not sold. Unrealized gains and losses are recognized in circumstances in which investments are carried at fair value. If the investment is carried at cost, consolidated, or reported using the equity method, unrealized gains and losses are not recognized.

Auditors of entities with significant equity investments should consider possible disclosure about market fluctuations that occurred after the opinion date but before the report is delivered to the client as subsequent events given the recent high degree of volatility in the stock market. For example, if the balance sheet date is June 31, 2001 and the opinion date is August 31, 2001, both of which occurred before a material market decline with the reports not being

delivered to the client until September 30, 2001, which was after the market decline, with no mention of the decline as a subsequent event. This may require double-dating the opinion or updating the cutoff and representation work to the later date.

Realized gains and losses are recognized in circumstances in which the organization sells or otherwise disposes of the investment. FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, requires gains and losses recognized on investments to be reported in the statement of activities as changes in unrestricted net assets unless their use is temporarily or permanently restricted by explicit donor-imposed stipulations or by law. If realized gains and losses arise when an organization sells or otherwise disposes of investments for which unrealized gains and losses have been recognized in the statement of activities of prior reporting periods, the amount reported in the statement of activities as gains or losses upon the sale or other disposition of the investments should exclude the amount that has previously been recognized in the statement of activities. However, the components of that gain or loss may be reported as the realized amount (the difference between the amortized cost and the sales proceeds) and the unrealized amount recognized in the prior reporting periods.

Example of Reporting Gains and Losses

In 20X1, a not-for-profit organization with a December 31 year-end purchased an equity security with a readily determinable fair value for \$10,000. At December 31, 20X1, the fair value of the security is \$12,000. During 20X2, the not-for-profit organization sells the security for \$16,000.

- In 20X1, the not-for-profit organization will recognize a \$2,000 gain and adjust the carrying value to \$12,000. (The reported gain equals \$12,000 fair value less \$10,000 carrying value.)
- In 20X2, the not-for-profit will recognize a \$4,000 gain and adjust the carrying value to zero. (The gain may be reported as the net of \$16,000 selling price less \$12,000 carrying value at the time the security was sold. Alternatively, the gain may be displayed as the realized gain of \$6,000

[\$16,000 selling price less \$10,000] less the \$2,000 unrealized gain previously recognized.)

SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*

The accounting and reporting requirements of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, apply to any entity that lends to or finances the activities of others. At first glance, some may not think that SOP 01-6 applies to NPOs. In fact, it does. Below is a list of some examples of NPO activities that may require the application of the requirements of SOP 01-6:

- Not-for-profits in the college and university sector loaning money to students to finance their education
- Organizations receiving advances from third parties to make loans to the NPO's constituents
- An NPO providing funds to individuals who agree to relocate due to a planned move to assist in their relocation. The funds are secured by the first or second mortgages on the personal residential properties.
- A church borrows from individuals, usually church members, and then loans the funds to other local churches for building construction and acquisition.

Management of NPOs and auditors should familiarize themselves with the requirements of SOP 01-6 and determine its applicability to the organization's financial statements.

Embedded Derivatives: Application of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to a Not-for-Profit Organization's Obligation Arising from a Split-Interest Agreement

In April 2002, the FASB's Derivatives Implementation Group issued implementation guidance Issue No. B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement*. That

implementation guidance supersedes certain guidance in Chapter 6, “Split-Interest Agreements,” of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* regarding measurement of the liability for unitrusts (split-interest agreements with variable payments) with either period-certain payments or period-certain-plus-life-contingent payments. Specifically, the implementation guidance requires that that liability be measured at fair value; thus, in circumstances in which the fair value is measured using present-value calculations, the discount rate assumptions should be revised at each measurement date to reflect current market conditions. A copy of the implementation guidance is included in the NPO Guide as Appendix B to Chapter 6 or at www.fasb.org. The effective date of the implementation guidance is the first day of the first fiscal year beginning after June 15, 2002.

Agency Transactions

Not-for-profit organizations sometimes become involved in agency transactions in which a donor transfers assets to the organization as an agent for the eventual benefit of a third-party beneficiary. These transactions have become more common as an indirect effect of the terrorist attacks on our country (for example, if a not-for-profit organization receives contributions locally for the benefit of a relief organization and then passes those funds through to the relief organization.)

Given the increase in these kinds of transactions, practitioners are reminded that guidance on accounting for agency transactions is provided by FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, and Chapter 5 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*.

Reporting the Costs of Soliciting Contributed Services

Over the past year, questions have continued to arise about reporting the costs of soliciting contributed services that do not meet the recognition criteria for contributions in FASB Statement No. 116. The AICPA’s Accounting Standards Executive Committee (AcSEC) developed a prospectus for a proposed Statement of Position to ad-

dress this issue. At its March 27, 2002 meeting, the FASB objected to AcSEC's undertaking a project to address this issue. The FASB believes a project is not necessary to clarify the existing GAAP that addresses this issue. The FASB believes that paragraphs 26–28 of FASB Statement No. 117 require that information about expenses be reported by functional classification and that fund-raising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in Statement No. 116. The FASB also observed that the definition of *fund-raising activities* in paragraph 13.35 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations* conforms to paragraphs 26–28 of Statement No. 117 and provides that costs of soliciting donors to contribute services (time) should be reported as fund-raising activities regardless of whether those services meet the recognition criteria for contributions in Statement No. 116. (The FASB observed that that conclusion also is articulated in the March 2000 AICPA Technical Practice Aid No. 6140.11, *Costs of Soliciting Contributed Services and Time That Do Not Meet the Recognition Criteria in FASB Statement No. 116*.)

1. Although government auditing standards primarily apply to federal financial assistance, some states have adopted government auditing standards.
2. Instead of a single audit, under certain circumstances, program-specific audits may be conducted.
3. For further information on this topic, The AICPA's Management of an Accounting Practice Handbook (Product No. 090407), provides guidance on audit documentation retention.
4. Some auditors have been unaware that SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is updated annually for conforming changes, including changes resulting from last year's two Yellow Book amendments. Although the AICPA does not normally make conforming changes to SOPs, SOP 98-3 has been, and will continue to be, revised annually to keep it up-to-date for changes in the Yellow Book, single audit literature and processes, and Statements on Auditing Standards.

Auditing and Attestation Pronouncements and Guidance Update

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert—2001/2002* (Product No. 022250kk) contains a summary explanation of all these issuances. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at 1-888-777-7077 or go online at www.cpa2biz.com.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SOP 01-3	<i>Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law</i>
SOP 01-4	<i>Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards</i>
SSAE No. 10	<i>Attestation Standards: Revision and Recodification</i>
SSAE No. 11	<i>Attest Documentation, amends Statement on Standards for Attestation Engagement No. 10, Attestation Standards: Revision and Recodification</i>
Audit Guide	<i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i>
Audit Guide	<i>Auditing Revenue in Certain Industries</i>
Audit Guide	<i>Audit Sampling Audit Guide Analytical Procedures</i>
Audit Guide	<i>Service Organizations</i>
Practice Alert 01-1	<i>Common Peer Review Recommendations</i>

New Auditing Interpretations

Auditing Interpretations are issued by the Auditing Issues Task Force of the ASB to provide timely guidance on the application of

ASB pronouncements. Interpretations are reviewed by the ASB but are not as authoritative as ASB pronouncements. Nevertheless, a departure from an Interpretation may have to be justified if the quality of a member's work is questioned. Interpretations become effective upon their publication in the *Journal of Accountancy*.

The new Interpretations listed below are available on the AICPA Web site at www.aicpa.org/members/div/auditstd/announce/index.htm.

Interpretation No. 1, "The Use of Legal Interpretation as Evidential Matter to Support Management's Assertions that a Transfer of Financial Assets has Met the Isolation Criterion for paragraph 9(a) of Financial Accounting Standards Board Statement No. 140," of SAS No. 73, *Using the Work of a Specialist*, (AICPA, *Professional Standards*, vol. 1, AU sec. 9336), supersedes Interpretation No. 1, "The Use of Legal Interpretation as Evidential Matter to Support Management's Assertions that a Transfer of Financial Assets has Met the Isolation Criterion for paragraph 9(a) of Financial Accounting Standards Board No. 125," issued in February 1998 and amended in October 1998

Interpretation No. 4, "Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls," of SAS No. 70, *Service Organizations*, (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.32-.37)

Interpretation No. 5, "Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods" of SAS No. 70, *Service Organizations*, (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.38-.40)

Interpretation No. 6, "Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement," of SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.41-.42)

Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of SAS No. SAS No. 93, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.56-.59)

Accounting Pronouncements and Guidance Update

Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. The AICPA general *Audit Risk Alert—2001/2002* (Product No. 022250kk) contains a summary explanation of all these issuances. For information

on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 141	Business Combinations
FASB Statement No. 142	<i>Goodwill and Other Intangible Assets</i>
FASB Statement No. 143	<i>Accounting for Asset Retirement Obligations</i>
FASB Statement No. 144	<i>Accounting for the Impairment or Disposal of Long-Lived Assets</i>
FASB Technical Bulletin No. 01-1	<i>Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets</i>
SOP 01-5	<i>NAIC Codification (amendment to certain insurance SOP's)</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others</i>
AICPA Audit and Questions and Answers	<i>Audits of Investment Companies</i> <i>FASB Statement No. 140</i>

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is some brief information about some ongoing projects that are especially relevant to the NPO industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS. The AICPA general *Audit Risk Alert—2001/2002* summarizes some of the more significant exposure drafts outstanding .

The following table lists the various standard-setting bodies' web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft.

<i>Standard Setting Body</i>	<i>Web site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	http://www.aicpa.org/members/div/acctstd/edo/index.htm
FASB	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committees	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA’s standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate “exposure draft email list” in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

New Framework for the Audit Process

The ASB is reviewing the auditor’s consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client’s business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in 2002. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the “Expectation Gap” standards were issued in 1988.

Some of the more important changes to the standards that are expected to be proposed are the following:

- A requirement for a more robust understanding of the entity’s business and environment that is more clearly linked to the assessment of the risk of material misstatement of the fi-

nancial statements (Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.)

- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Combinations of Not-for-Profit Organizations

In November 1999, the FASB affirmed its earlier decision to undertake a project on combinations of NPOs that is separate from its business combinations project. As a result of that decision, combinations of NPOs are excluded from the scope of FASB Statement No. 141, *Business Combinations*. The FASB also agreed to delay the effective date of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, as it applies to combinations of NPOs, until the FASB addresses the issues related to such combinations.

The objective of this project is to develop guidance on the accounting and reporting for combinations of NPOs. As of the end of the fourth quarter of 2000, the FASB had substantially completed its deliberations related to the issues of the following:

-
- The method of accounting for combinations of NPOs
 - The criteria to be used to identify the acquiring NPO

In the first quarter of 2001, the FASB Board decided that because progress on the remaining issues in this project depend on developments in the business combinations project, consideration of those issues should be deferred until *after* the final Statements on business combinations were issued (end of June 2001). The FASB Board also decided that it would consider the accounting for intangible assets acquired by NFP organizations as part of this project. That means that NPOs will account for acquired intangible assets following the guidance in Accounting Principles Board (APB) Opinion No. 17, *Intangible Assets*, until a final Statement on combinations of NPOs is issued and effective.

Costs of Soliciting Contributed Services

At the March 27, 2002, meeting of the AcSEC, the FASB discussed a prospectus for a proposed SOP on reporting the costs of soliciting contributed services that do not meet the recognition criteria for contributions in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. The FASB objected to AcSEC's undertaking a project to address the reporting of costs of soliciting contributions of services that do not meet the criteria for recognition as contribution revenue in FASB Statement No. 116. The FASB believes a project is not necessary to clarify the existing GAAP that addresses this issue. The FASB further believes that paragraphs 26–28 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, require that information about expenses be reported by functional classification and that fund-raising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in FASB Statement 116. The FASB also observed that the definition of fund-raising activities in paragraph 13.35 of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, conforms to paragraphs 26–28 of FASB Statement No. 117 and provides that costs of soliciting donors to

contribute services (time) should be reported as fund-raising activities regardless of whether those services meet the recognition criteria for contributions in FASB Statement No. 116. (That conclusion also is articulated in the March 2000 AICPA Technical Practice Aid No. 6140.11, *Costs of Soliciting Contributed Services and Time That Do Not Meet The Recognition Criteria in FASB Statement No. 116*.) The Board suggested that AcSEC consider how best to communicate the final resolution of this issue in the next edition of the Guide.

Potential Technical Practice Aids

AcSEC has also approved a Technical Practice Aid (TPA) Q&A (subject to FASB staff consideration) related to the contribution of a hospital by a not-for-profit. Potential TPAs on FASB Statement No. 136 and four other various topics.

AICPA Audit and Accounting Products and Services

Industry Conference

The AICPA will hold its Ninth Annual Not-for-Profit Organizations Industry Conference on June 13 to June 14, 2002 (with preconference workshops on June 12), in Washington, D.C. The conference is designed for both practitioners and not-for-profit organization financial executives, and will provide technical information for those decision makers. Also coming up is the AICPA National Government and Not-for-Profit Training Program on October 21 to October 23, 2002, in Las Vegas, NV. For further information, call the AICPA CPE Conference Hotline at 1-888-777-7077 or visit the AICPA Web site at www.aicpa.org.

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call 1-888-777-7077.

Ethics Hotline

The AICPA Professional Ethics Team answers inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call 1-888-777-7077.

Continuing Professional Education Courses

The AICPA offers many continuing professional education (CPE) courses related to NPOs, many of them available for both group study and self-study. Among the available titles are the following:

- REVISED! Accounting and Reporting Practices of Non-profit Organizations (Product No. 743269kk)
- REVISED! The AICPA Form 990 Nonprofits Workshop (Product No. 731052kk)
- Compensation Issues in Not-for-Profit Organizations (Product No. 730728kk)
- Advanced Accounting and Auditing Problems for NPOs (Product No. 730127kk)
- Advanced Auditing of HUD-Assisted Projects (Product No. 730186kk)
- Applying A-133 to Nonprofit and Governmental Organizations (Product No. 730196kk)
- Applying Fraud SAS No. 82 in Governmental and Not-for-Profit Audits (Product No. 735136kk)
- Audits of HUD-Assisted Projects (Product No. 730291kk)
- Analytical Procedures for Nonprofit Organizations (Product No. 730210kk)
- Budget Building for Nonprofits (Product No. 730252kk)
- Cost Allocation Methods for Not-For-Profit Organizations (Product No. 730410kk)

-
-
- Managing Nonprofit Organizations Like a Business (Product No. 730341kk)
 - New Edition! Nonprofit Accounting and Auditing Update (2001-2002 Edition) (available in text Product No. 732066kk and video Product No. 182066kk)
 - Nonprofit Auditing: Auditing Financial Results and Compliance Requirements (Product No. 737052kk)
 - Planned Giving: Strategies for Donor and Recipient (Product No. 732236kk)
 - Tax Mysteries of Private Foundations (Product No. 732241kk)
 - Solving Complex Single Audit Issues for Government and Nonprofit Organizations (available in text Product No. 734404kk and video Product No. 184402kk)
 - Getting Started with Not-for-Profit Organization Tax Issues (Product No. 733802kk)
 - Tackling Tough Tax Topics in Nonprofit Organizations (Product No. 736762kk)
 - Using the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*
 - Workpaper Preparation Techniques for Government and Nonprofit Organizations (available in text Product No. 732629kk and video Product No. 182630kk)
 - Yellow Book: Government Auditing Standards (Product No. 736109kk)

For more information about AICPA CPE courses, call the AICPA (Member Satisfaction) at 1-888-777-7077 or visit the AICPA Web site at www.aicpa.org.

Not-for-Profit Organizations Checklists

The AICPA Accounting and Auditing Publications Team publishes *Checklists and Illustrative Financial Statements for Not-for-Profit Organizations* (Product No. 008786KK), a nonauthoritative pub-

lication designed to help those preparing reports and financial statements of NPOs.

Practice Aids

Financial Statement Presentation and Disclosure Practices for Not-for-Profit Organizations is a comprehensive Practice Aid (Product No. 006605KK) that illustrates a wide variety of NPOs financial statement formats and disclosures to assist auditors of NPOs.

Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, is a two-volume set (Product No. 008730kk) containing comprehensive analyses of the OMB's revisions to its Circulars for performing single audits, numerous checklists, and illustrative examples, and an illustrative case study of the single audit process.

Technical Practice Aids

AICPA Technical Practice Aids includes questions received by the AICPA Technical Hotline on various subjects and the responses to those questions. Sections 6140 and 6960 of *Technical Practice Aids* include questions and answers specifically pertaining to NPOs. *Technical Practice Aids* is available both as a subscription service (Product No. G01013kk) and in paperback form (Product No. 005059kk).

Help Desk—AICPA publications can be obtained by calling the AICPA Order Department (Member Satisfaction) at 1-888-777-7077, or faxing a request to 1-800-362-5066.

References for Additional Guidance

Federal Agencies—Administrative Regulations

Most federal agencies issue general administrative regulations that apply to their programs and that provide general rules on how to apply for grants and contracts, how grants are made, the general conditions that apply to and the administrative responsibilities of grantees and contractors, and the compliance procedures used by

the various agencies. Those regulations are included in the *Code of Federal Regulations*.

General Accounting Office

The General Accounting Office (GAO) home page, on the Internet at www.gao.gov, contains links to the hundreds of reports and testimony to the Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Hard copies of GAO reports and testimony can be obtained from the GAO, P.O. Box 37050, Washington, DC 20013; phone 1-202-512-6000; fax 1-202-512-6061; or www.gao.gov/cgi-bin/ordtab.pl.

GAO's Web site is updated daily and also includes Comptroller General decisions and legal opinions; GAO policy documents; and special publications. You may subscribe to GAO daily electronic alerts using the form at www.gao.gov/subtest/subscribe.html.

The following publications are available on the GAO Web site at www.gao.gov/govaud/ybk01.htm. The first three publications also are available through the Superintendent of Documents, U.S. Government Printing Office (GPO), P.O. Box 371954, Pittsburgh, PA 15250-7954; phone 1-202-512-1800; fax 1-202-512-2250; or bookstore.gpo.gov/index.html.

- *Government Auditing Standards, 1994 Revision*—These standards relate to financial and performance audits of governmental organizations, programs, activities, and functions, and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. (GPO Stock No. 020-000-00-265-4) There also is a codification of the 1994 standards that includes the Government Auditing Standards Amendments on the GAO Web site.
- *Government Auditing Standards: Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*—This amendment establishes a fieldwork standard requiring documentation in the planning of

financial statement audits in certain circumstances. (GPO Stock No. 020-000-00275-1)

- *Government Auditing Standards: Amendment No. 2, Auditor Communication*—This amendment requires specific communication concerning the auditor’s work on compliance with laws and regulations and internal control over financial reporting. It also requires the auditor to emphasize in the auditor’s report on the financial statements the importance of the reports on compliance with laws and regulations and internal control over financial reporting when these reports are issued separately from the report on the financial statements. (GPO Stock No. 020-000-00274-3)
- *Government Auditing Standards: Amendment No. 3, Independence*—This amendment establishes independence standards for CPAs, non-CPAs, government auditors, and performance auditors. It addresses a range of auditor independence issues, including restrictions on nonaudit services.
- *Interpretation of Continuing Education and Training Requirements*—Government Auditing Standards establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This Interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community.

Office of Management and Budget

Circulars

The OMB issues cost and grants management circulars to establish uniform policies and rules to be observed by federal agencies for the administration of federal grants. Federal agencies then adopt these circulars in their regulations. The process for issuing circulars includes due process, with a notice of any proposed changes in the *Federal Register*, a comment period, and careful consideration of all responses before issuance of final circulars. The following table includes a list of circulars relevant to audits of not-for-profit organiza-

tions. Copies of these circulars are available under the grants management heading on the OMB Web site at www.omb.gov.

OMB Circulars Relevant to Audits of Not-for-Profit Organizations

<i>Circular Number</i>	<i>Title</i>	<i>Issue Date</i>
A-21 (Revised)	Cost Principles for Educational Institutions	August 2000
A-122 (Revised)	Cost Principles for Non-Profit Organizations	May 1998
A-110 (Revised)	Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations	September 1999
A-133 (Revised)	Audits of States, Local Governments, and Nonprofit Organizations	June 1997

OMB Circular A-133 Compliance Supplement

The Supplement (appendix B in OMB Circular A-133) sets forth the major federal compliance requirements to consider in a Circular A-133 audit of states, local governments, and nonprofit organizations that receive federal assistance. You can find the 2002 Supplement (and the preceding 2001 Supplement) on the OMB's Web site at the grants management address, www.omb.gov/grants. You may purchase a printed copy (Product No. 041-001-00580-3) or CD ROM version (Product No. 041-001-00581-1) of the 2002 Supplement from the Government Printing Office at 1-202-512-1800.

Other Guidance

Standard forms prescribed by OMB's grants management circulars can be obtained on the grants management section of OMB's Web site (see above). The data collection form (Form SF-SAC), which is required to be completed for all Circular A-133 audits, can be completed online at the Federal Audit Clearinghouse Web site at harvester.census.gov/sac. That site also has PDF versions of the data collection form.

The Catalog of Federal Domestic Assistance (CFDA) is a government-wide compendium of federal programs, projects, services, and activities that provide assistance or benefits to the public. Program

information provided by the CFDA includes authorizing legislation and audit requirements. The General Services Administration (GSA) is responsible for the dissemination of federal domestic assistance information through the catalog and maintains the information database from which program information is obtained. A searchable version of the CFDA is located at www.cfda.gov.

The GSA also makes copies of the CFDA available to certain specified national, state, and local government offices. You can locate those depositories through the GSA Web site at www.gsa.gov. The CFDA also may be purchased from the GPO by calling 1-202-512-1800 or through the online bookstore at www.gpo.gov.

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in the AICPA general *Audit Risk Alert—2001/2002* (Product No. 022260kk), and AICPA *Compilation and Review Alert—2001/2002* (Product No. 022270kk). These Alerts may be obtained by calling the AICPA Order Department (Member Satisfaction) at 1-888-777-7077 or faxing a request to 1-800-362-5066. Obtaining product information and placing online orders can be done at www.CPAweb.org. (The 2001/2002 version of these publications will be issued later in 2002).

Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at 1-800-748-0659.

PCIE Audit Committee Guidance

The PCIE Audit Committee publishes supplemental, nonauthoritative guidance for federal officials addressing issues arising from the implementation of the Single Audit Act and related OMB Circulars.

Over the years, the PCIE Audit Committee (or its predecessors) has issued a total of six position statements. Most of these position statements were developed to address issues related to audits conducted under the Single Audit Act of 1984, Circular A-128, and the March 1990 version of Circular A-133. Only PCIE Statement No. 4, which establishes uniform procedures for referrals of sub-

standard audits to state boards of accountancy and the AICPA, continues to be applicable to audits conducted under the Single Audit Act Amendments of 1996 and the June 1997 Circular A-133. You can find PCIE Statement No. 4 on IGnet, the Inspectors General Web site, in the Single Audit Library. The Internet address for that library is www.ignet.gov/pande/audit/mains.html.

Note that the PCIE Audit Committee also is responsible for developing nonfederal audit review guidelines in the form of a desk review guide and a quality control review guide. Those guides, which have been updated for the Single Audit Act Amendments of 1996 and the June 1997 revision to Circular A-133, are available at the Internet address in the paragraph above.

.....

This Audit Risk Alert replaces *Not-for-Profit Organizations Industry Developments—2001*. The *Not-for-Profit Organizations Industry Developments* Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would be appreciated. You may e-mail these comments to lwest@aicpa.org or write to:

Lori A. West CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

Circular A-133 Audit Refresher—Major Programs

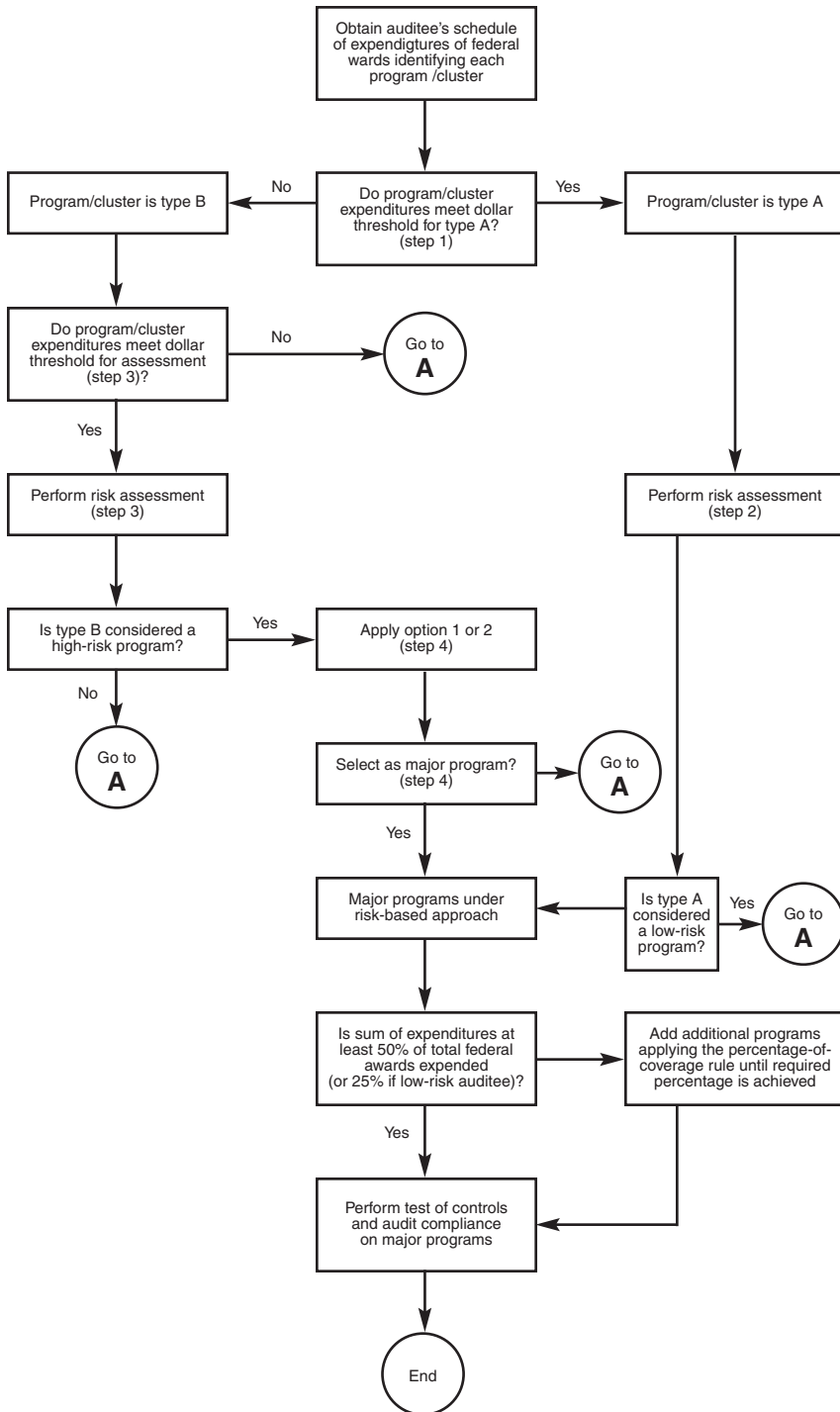
As discussed elsewhere in this Alert, various organizations that monitor the quality of not-for-profit audits are identifying problem areas that include Circular A-133's requirements for applying a risk-based approach to determining major programs. Those requirements are designed to focus the Circular A-133 audit on higher risk programs. To complement that discussion, we present this "refresher" on Circular A-133's requirements for major program selection. Auditors also should refer to Circular A-133 and chapter 7 of SOP 98-3 for the underlying requirements.

Determining major programs using the risk-based approach is a four-step process that involves the auditor (1) determining type A and type B programs, (2) identifying low-risk type A programs, (3) identifying high-risk type B programs, and (4) selecting major programs. The following flowchart from chapter 7 of SOP 98-3 illustrates this process.

Only in situations of a "first-year" audit can the auditor deviate from using the risk-based approach. Section 520(i) of Circular A-133 defines a first-year audit as the first year an entity is audited under the June 30, 1997, revision to Circular A-133 or as the first year of a change in auditors. That exception allows the auditor to elect to determine major programs as all type A programs plus any type B programs as are necessary to meet the percentage-of-coverage rule described in step 4. However, to ensure that a frequent change of auditors will not preclude the audit of high-risk type B programs, the election for first-year audits may not be used more than once every three years.

Step 1—Determining Type A and Type B Programs

To select major programs, the auditor must first identify federal programs as being either type A or type B as defined in Circular A-



133, section 520(b). In general, type A programs are larger federal programs, and type B programs are smaller federal programs. For purposes of determining major programs, a cluster of programs¹ is considered one program. For example, if the auditee expends federal awards under more than one program in the child nutrition cluster (which is comprised of the school breakfast program, the national school lunch program, the special milk program for children, and the summer food service program for children), those programs should be considered together as one program.

Type A programs depend on an auditee’s total federal awards expended, as shown in the following table. Federal programs that do not meet the type A criteria are type B programs:

<i>When Total Federal Cash and Noncash Awards Expended Are—</i>	<i>Type A Programs Are Any Programs With Federal Awards Expended That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to \$100 million	\$300,000 or 3 percent (0.03) of federal awards expended
More than \$100 million and less than or equal to \$10 billion	\$3 million or 0.3 percent (0.003) of federal awards expended
More than \$10 billion	\$30 million or 0.15 percent (0.0015) of federal awards expended

If an auditee’s federal awards expended include loans and loan guarantees,² the auditor may need to adjust how to apply the above criteria. Circular A-133 states that, when identifying type A programs, the inclusion of large loans and loan guarantees should not result in the exclusion of other federal programs as type A programs. This requirement relates only to loans and loan guarantees and not to any other noncash awards. When, based on the auditor’s professional judgment, federal programs providing loans or loan guarantees significantly affect the number or size of type A programs, the auditor

1. A *cluster of programs* is defined as a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development, student financial aid, and other clusters. “Other clusters” are defined in the OMB Circular A-133 *Compliance Supplement* or are designated by a state for federal awards that the state provides to its subrecipients that meet the definition of a cluster of programs.

2. As provided in Circular A-133, sections 105 and 215(b) through (d), loans and loan guarantees represent federal awards.

should consider the loan or loan guarantee programs type A programs and exclude their value in determining other type A programs. An example of this concept is shown in paragraphs 7.8 and 7.9 of SOP 98-3.

Federal awards expended for purposes of determining type A and B programs is the amount of cash and noncash awards, after all audit adjustments are made, shown on the face of the current-year schedule of expenditures of federal awards, including the notes thereto, and in the data collection form. An auditor who uses the prior-year schedule or preliminary current-year estimates to plan the audit should recalculate the threshold for type A programs based on the final amounts to ensure that federal awards are properly classified as type A or B. Although the calculation of the threshold (and the percentage-of-coverage requirement discussed in step 4) seems straightforward, some auditors are not complying with the requirement. Rounding the calculation is not allowed; if the type A threshold calculates to \$4,893,000, the auditor cannot round the number to \$4.9 million.

Step 2—Identifying Low-Risk Type A Programs

After completing step 1, the auditor should perform a risk assessment of each type A program to identify those that are low risk as provided in section 520(c) of Circular A-133. For a type A program to be considered low risk, both of the following conditions must be met:

1. The program has been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and
2. In the most recent audit period, the program had no audit findings that represent reportable conditions in the internal control over major programs or material noncompliance with the provisions of laws, regulations, contracts, or grant agreements that are related to a major program.

There is no auditor judgment involved in meeting either of these criteria. The fact that a type A program was not type A in the pre-

vious two years is not relevant. If a type A program was not audited in the two most recent audit periods, without regard to whether it was type A or type B during those periods, it cannot be considered low risk and, therefore, must be audited in the current period. Similarly, if an auditee did not previously participate in a federal award program that is a type A program in the current year, that program was not audited in the two most recent audit periods and cannot be considered low risk.

Except in the situations discussed in the previous paragraph, Circular A-133 permits the auditor to conclude, based on professional judgment, that a type A program is low risk even though (a) in the prior audit period it may have had known or likely questioned costs greater than \$10,000 for a type of compliance requirement, (b) known fraud has been identified, or (c) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. SOP 98-3 gives the following example in which the auditor, based on professional judgment, could decide that the program is low-risk in the current year: Funds expended under a federal program in the prior year totalled \$10 million, there were known questioned costs of \$11,000 that related to one isolated instance, and there were no additional likely questioned costs.

In making the final determination of whether a type A program is low-risk, the auditor also should consider the following risk criteria:

- The nature of oversight exercised by federal agencies and pass-through entities
- The inherent risk of the program
- The results of audit follow-up
- Whether any changes in the personnel or systems affecting a type A program have significantly increased its risk
- The identification by the federal agency, as provided by the OMB in the *Compliance Supplement*, that a program is higher risk

Step 3—Identifying High-Risk Type B Programs

After completing steps 1 and 2, the auditor should identify type B programs that are high risk. Step 3 is discussed in section 520(d) of Circular A-133. Before risk assessing type B programs, the auditor should consider whether there are low-risk type A programs:

- When there are no low-risk type A programs (either because there are no type A programs or because none of the type A programs are low risk), the auditor is not required to perform step 3.
- When there are no Type A programs, the auditor would audit as major enough programs to meet the percentage-of-coverage rule, as discussed below in step 4.
- When none of the type A programs are low risk, the auditor would audit as major all type A programs plus any additional type B programs needed to meet the percentage-of-coverage rule.

Option 1 or option 2 will be used in step 4 as discussed below. The auditor's decision of which option to choose will likely be based on audit efficiency and will affect how many type B programs are subject to risk assessment. Under option 1, the auditor is required to perform a risk assessment on all type B programs (except small type B programs as discussed below). In comparison with option 2, option 1 will likely require the auditor to perform more type B program risk assessments, but may also result in the auditor having to audit fewer major programs. Under option 2, the auditor is only required to identify high-risk type B programs up to the number of low-risk type A programs. In comparison with option 1, option 2 will likely require the auditor to perform fewer type B risk assessments, but may also result in the auditor having to audit more major programs. Paragraph 7.15 of SOP 98-3 provides examples of these concepts. Under either option, any programs that a federal agency or pass-through entity requests be audited as discussed in step 4 below must be audited as a major program.

An auditor is not expected to perform risk assessments on relatively small federal programs. Circular A-133 only requires the auditor to

perform risk assessments on type B programs as shown in the following table.

<i>When Total Federal Cash and Noncash Awards Expended Are—</i>	<i>Perform Risk Assessment for Type B Programs That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to, \$100 million	\$100,000 or 3 percent (0.03) of federal awards expended
More than \$100 million	\$300,000 or 0.3 percent (0.003) of federal awards expended

The auditor should identify type B programs that are high-risk using professional judgment, the risk criteria bulleted above in step 2 for type A programs, and the following additional risk criteria for type B programs:

- Weaknesses in the internal control over compliance for the program
- Whether the program is administered under multiple internal control structures
- A weak system for monitoring subrecipients when significant parts of the program are passed through to subrecipients
- The extent to which computer processing is used
- Prior audit findings that have a significant impact on a program or for which no corrective action has been implemented since the findings were identified.
- The program has not recently been audited as major

Except for known reportable conditions in internal control or instances of noncompliance, a single-risk criteria would, in general, seldom cause a type B program to be considered high risk.

Step 4—Selecting Major Programs

After completing steps 1 through 3, the auditor identifies major programs. At a minimum, sections 215(c) and 520(e) of Circular A-133 requires the auditor to audit all of the following as major programs:

-
-
- All type A programs, except those identified as low risk under step 2
 - High-risk type B programs as identified under either of the two options described below
 - Programs to be audited as major based on a federal agency request, in lieu of the federal agency conducting or arranging for additional audits as discussed below
 - Additional programs, if any, that are necessary to meet the percentage-of-coverage rule described below

Section 520(e)(2) of Circular A-133 provides two options for identifying high-risk type B programs.

- Under option 1, the auditor is expected to perform risk assessments of all type B programs that exceed the amount specified in the table shown in step 3, and to audit at least one-half of the high-risk type B programs as major, unless that number exceeds the number of low-risk type A programs identified in step 2 (that is, the cap). In this case, the auditor would be required to audit as major the same number of high-risk type B programs as the cap.
- Under option 2, the auditor is only required to audit as major one high-risk type B program for each type A program identified as low risk in step 2. Under this option the auditor would not be required to perform risk assessments for any type B program when there are no low-risk type A programs (that is, the cap is zero).

Paragraph 7.18 of SOP 98-3 provides an example of the application of these options. The auditor may choose option 1 or option 2. There is no requirement to justify the reasons for selecting either option. The results under options 1 and 2 may vary significantly, depending on the number of low-risk type A programs and high-risk type B programs. Circular A-133 encourages the auditor to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

Section 215(c) of Circular A-133 provides for a federal agency to request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests are required to be made at least 180 days before the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if it would not, the estimated incremental cost to audit the program as a major program. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based on the federal agency's request, and the federal agency has agreed to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach also may be used by pass-through entities for a subrecipient.

Circular A-133 requires the auditor to audit, as major programs, federal programs with federal awards expended that, in the aggregate, encompass at least 50 percent of the total federal awards expended unless the auditee meets the criteria for a low-risk auditee, as discussed below. If the auditee is a low-risk auditee, the auditor is only required to audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of the total federal awards expended. (Again, rounding the calculation is not allowed.) If the total major programs selected do not equal 50 percent (or 25 percent in the case of a low-risk auditee) of the total federal awards expended, the auditor should select additional programs (either type A or type B) to equal the applicable percentage and test them as major programs. The auditor may select additional programs to meet the percentage-of-coverage rule based on professional judgment and without regard to risk assessment. The auditor should apply the percentage-of-coverage rule after all other steps in the risk-based approach are completed. The auditor can not just select programs comprising 50 percent of federal awards expended without completing the other steps.

Section 530 of Circular A-133 establishes certain conditions for determining whether an auditee is low-risk. An auditee that meets all of the following conditions for each of the preceding two years (or in the case of biennial audits, the preceding two audit periods) qualifies as a low-risk auditee and is eligible for 25 percentage –of coverage as discussed above:

- Single audits were performed on an annual basis in accordance with Circular A-133. An auditee that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- The auditor’s opinions on the financial statements and the schedule of expenditures of federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of federal awards and may provide a waiver.
- There were no deficiencies in internal control over financial reporting that were identified as material weaknesses under the requirements of *Government Auditing Standards*. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of federal awards and may provide a waiver.
- None of the federal programs classified as type A programs in either of the preceding two years (or in the case of biennial audits, the preceding two audit periods) had audit findings from any of the following: (a) material weaknesses in the internal control over compliance, (b) noncompliance with the provisions of laws, regulations, contracts, or grant agreements that have a material effect on the type A program, and (c) known or likely questioned costs that exceed 5 percent of the total federal awards expended for a type A program during the year.

Section 520(g) of Circular A-133 requires that there be audit documentation of the risk assessment process used in determining major programs. It is therefore necessary for the auditor to document adequately, as required by generally accepted auditing standards (GAAS) and *Government Auditing Standards*, the determination of major programs.

Schedule of Findings and Questioned Costs and Data Collection Form

Information needed to determine major programs is required to be reported on the schedule of findings and questioned costs and the data collection form. For example, the schedule and form require the auditor to report the dollar threshold to distinguish type A and B programs and whether the auditee qualifies as low risk. The auditor should review the information on the schedule and form to ensure that it is consistent with the information developed during the audit and consistent between the schedule and the form.

Help Desk—The AICPA Practice Aid, Auditing Recipients of Federal Awards: Practical Guide for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, Second Edition, includes practical checklists for performing risk assessments and selecting major programs.

The Internet—An Auditor's Research Tool

Can auditors use the Internet to perform more efficient audits?

If used properly, the Internet can be a valuable tool for auditors. Through the Internet, auditors can access a wide variety of global business information. For example, information is available relating to industry statistics, resources for NPOs and their finance professionals, professional news, state CPA society information, Internal Revenue Service information, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are such materials accessible from the computer, but they are available at any time, often free of charge.

A number of resources provide direct information, whereas others may simply point to information inside and outside of the Internet. Auditors can use the Internet to—

- Obtain audit and accounting research information.
- Obtain texts, such as audit programs.
- Discuss audit issues with peers.
- Communicate with audit clients.
- Obtain information from a client's Web site.
- Obtain information on professional associations.

There are caveats to keep in mind when using the Internet. Reliability varies considerably. Some information on the Internet has not been reviewed or checked for accuracy; caution is advised when accessing data from unknown or questionable sources. Although a vast amount of information is available on the Internet, much of it may be of little or no value to auditors. Accordingly, auditors should learn to use search engines effectively to minimize the amount of time browsing through useless information. The Internet is best used in

tandem with other research tools, because it is unlikely that all desired research can be conducted solely from Internet sources.

The following listing summarizes the various Web sites of many of the organizations referred to in this Audit Risk Alert, as well as others that auditors of not-for-profit organizations may find useful.

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
American Institute of CPA	Information for CPAs on accounting, auditing, industry activities, the activities of the AICPA, and other matters	http://www.aicpa.org
Accountant's	Resources for accountants and financial and business professionals	http://www.computercpa.HomePage.com
Action Without Borders	Includes a directory of not-for-profit organizations and volunteering resources, a newsletter on not-for-profit organization issues, and job postings	http://www.idealists.org
American Society of Association Executives	Provides resources to assist association executives and individuals from for-profit companies that provide products and services to the association community	http://www.asaenet.org
The Chronicle of Philanthropy	Articles from the Chronicle of Philanthropy newspaper and links to other sites	http://www.philanthropy.com
Council on Foundations	Includes research, publications, and other information of interest to foundations and corporate donors	http://www.cof.org
CPAnet	Links to other Web sites of interest to CPAs	http://www.cpalinks.com/
Department of Housing and Urban Development: Office of Inspector General Real Estate Assessment Center	Information on programs, resources, and other matters	http://www.hud.gov/oig http://www.hud.gov/offices/reac

(continued)

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
The Electronic Accountant	World Wide Web magazine that features up-to-the minute news for accountants	http://www.electronicaccountant.com
Financial Accounting Standards Board	Information on the activities of this standard-setting body	http://www.fasb.org
FedWorld.Gov	U.S. Department of Commerce sponsored site providing access to government publications	http://www.fedworld.gov
Financial Systems Forum	Topics involving the improvement of financial systems by providing information on methodologies, service organizations, and vendors with a focus on applications concerning accounts payable, accounts receivable, asset management, general ledger, and inventory	http://www.fsforum.com
The Foundation Center	Information for not-for-profit organizations, donors, and researchers	http://www.fdncenter.org
Giving USA	American Association of Fund-Raising Counsel sponsored site providing information trends in giving and sources of support	http://www.aafr.org
General Accounting Office	Policy and guidance materials, reports on federal agency major rules	http://www.gao.gov
Guidestar	Information on not-for-profit organizations and new and resources for not-for-profit organizations and donors	http://www.guidestar.org
Guide to WWW For Research and Auditing	Basic instructions on how to research tool	http://www.tetranet.net/
Hoovers Online	Online information on various companies and industries	http://www.hoovers.com
Independent Sector	A forum to encourage giving, volunteering, not-for-profit initiative and citizen action	http://www.indepsec.org

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Information for Tax-Exempt Organizations (an IRS site)	A Treasury Department site providing information and answers to frequently asked questions regarding tax-exempt organizations	http://www.irs.gov/
Internet Nonprofit Center	Includes the nonprofit locator, frequently asked questions, and other information	http://www.nonprofits.org
Management Assistance Program for Nonprofits	Includes the Nonprofit Manager's Library and other resources	http://www.mapnp.org
National Association of College and University Business Officers	Provides information geared to colleges and universities, including accounting tutorials on specific situations encountered in higher education accounting	http://www.nacubo.org
Board Source	Resources to help strengthen not-for-profit organization boards of directors	http://www.boardsource.org/main.htm
The National Center for Charitable Statistics	Provides statistics on revenue and expenses of not-for-profit organizations	http://nccs.urban.org
BBB Wise Giving Alliance	Promotes giving and helps contributors obtain accurate information about charitable organizations	http://www.give.org
The Nonprofit Genie	Advice, links to other sites, publications, and other information on not-for-profit organization management	http://www.genie.org
The Nonprofit Resource Center	Information and links to other sites covering financial management, governance, legal, and other matters	http://www.not-for-profit.org
The Nonprofit Risk Management Center	Provides information to help not-for-profit organizations control their risks	http://www.nonprofitrisk.org
The Nonprofit Times Online	Articles from the Nonprofit Times newspaper and links to other sites	http://www.nptimes.com

(continued)

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
CompassPoint Nonprofit Services	Workshops, consulting, publications, and other information and resources of interest to managers of not-for-profit organizations	http://www.support center.org
Tax Analysts Online	Provides information on current tax developments	http://www.tax.org
U.S. Department of Education	Information on programs, resources, and other matters	http://www.ed.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	http://www.fourmilab.ch/ ustax/ustax.html
U.S. Office of Management and Budget	OMB information and literature	http://www.whitehouse. gov/OMB/
Vision Project	Information on the profession's Vision Project	http://www.cpavision.org
